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INTRODUCTION

Civilization has been defined as an accumulation of luxuries. It is true that our modern life is largely made up of those things that once were viewed as luxuries, but which have demonstrated their usefulness in increasing our efficiency and our possibility of a fuller realization of life to such an extent that we will not do without them. One need only think of spending a week in journeying by stage-coach from Albany to Washington, to realize that our span of life has practically been doubled or trebled within the last century.

Of these erst-while luxuries that make our modern existence possible, the most fundamental consist of services rendered by a class of institutions which have come to be known as "public utilities." The peculiarity of this class of services is that its economy of production rests upon what is known in political economy as the "principle of increasing returns," or, in other words, these services can be produced most cheaply under systems of wide-spread, unified control. Because of the physical conditions involved in their production and distribution, gas, electric, transportation, and telephone services do not lend themselves to the regulative principle involved in competitive methods, and governmental control, either through regulation or ownership, has come to be considered indispensible.

But, if it is true, on the one hand, that our modern life would not be possible without these services, it is equally true that these "utility" services could not be possible without the equally modern practice of investment by the masses of the people in corporate securities. Not only is the corporate form of organization necessary for the production of these services, but the financial requirements are so great that popular support of their security-issues is absolutely necessary. A modern public utility corporation is just as dependent for its existence upon the investing public as upon the consuming public. A man may be practically compelled to patronize a public service corporation which enjoys a monopolistic position, but he cannot be forced in the matter of investing his funds.

The investment security was also classed among the luxuries, as instanced by the proverbial reference to the "bloated" bond-holder. In the early middle ages, banks were unknown, and surplus funds were hidden away. The first banks, when they did develop, were simply safe deposit vaults, and charged the depositors a fee for their services. This practice was succeeded by that of loaning out the deposits at a rate of

interest which would pay expenses and yield a return to the bankers. The next step, investment banking through corporate securities, came with the development of the corporate form of business organization, the present extent of which was made possible only through the collective investment of large numbers of individuals.

The underlying principle of the whole history of banking, and of investment in corporate securities, has been the growth of confidence of man in his fellowman, and this financial confidence is today the most fragile element of our social and economic structure. A financial catastrophe, such as overtook the New Haven Road, produces a shattering of this financial confidence which it takes years to overcome.

The situation, briefly stated, is, that these "utility" services are necessary to our present-day life; their production is, in its nature, monopolistic, and in need of government control in the matter of prices charged. On the other hand, in common with all large corporations, public utilities are dependent upon public participation in their securities, that is, upon the confidence of investors.

A reduction of rates through governmental agencies may result in a corporation's inability to meet bond-interest and thus throw it into bankruptcy, with attendant impairment both of securities and services, or, at least, may so shake confidence in its securities as to force it to pay exorbitant rates for needed funds. Of course, where securities are not in excess of the value of the property, investors are fully protected, but where they represent fictitious values, the problem of rate regulation is beset with difficulties. For a public utility corporation which is subject to control in the matter of rates but which can still pass on to honest investors securities not represented by value presents to a regulative body the dilemma of choosing between a reduction of unjustly high rates and a shaking of financial confidence. In other words, such a corporation can, through unwarranted issues of securities, succeed in placing the consuming and investing public in direct opposition to each other. Much of the pith in the noted remark about the difficulty of 'unscrambling scrambled eggs' lies in the fact that the courts have always shown great reluctance in sanctioning any action that would tend to work a hardship upon innocent holders for value. For the courts realize the ease with which this confidence can be destroyed and the difficulty of restoring it.

Hence, to give a regulative commission control over rates without a corresponding control over security issues is a half-way solution that can achieve but little real progress. The Interstate Commerce Commission, for instance, is such a body. That it feels the anomaly of its

position is evident in the remarks which it made in connection with a recent rate decision to the effect that until there was a permanent control of the issue of the securities of interstate carriers, investors could not be protected against losses.[1]

In view of this, the circumstances attending the adoption of the present system of administrative control of public utilities in New York state are of interest. In 1906, the situation in New York City, especially as to transit, had become intolerable. The large traction systems were so loaded down with excessive bond issues that they found it impossible to pay fixed charges and at the same time furnish adequate service, and, even as it was, they were on the point of bankruptcy. The attempts at regulation up to that time had proved futile, and many persons were convinced that public ownership was the only solution.

[1] On April 27th, 1918, the Interstate Commerce Commission granted certain increases in rates to the New York, New Haven and Hartford Railroad Company, and with seeming reluctance. The Commission took occasion to criticise the New Haven for its investments in other concerns within the last twelve years. "Money thrown away dishonestly or with wanton recklessness, or foolishly lost in non-railroad enterprises is not money put to public use on which the rate payers are bound in law and in conscience to make a return. . . . Until this Commission or some other active governmental body with absolute power permanently controls the issue of carrier securities, and, within reasonable limitation, the application of the proceeds thereof, stockholders and other investors in carrier securities are certain from time to time, to be subjected to such perils of mismanagement and resultant losses as have accrued to the stockholders of the New Haven, the Rock Island, the Pere Marquette, the Cincinnati, Hamilton and Dayton and others." In connection with this discussion, attention might be called to the effort made to reach the masses of the people during the liberty loan campaigns. The number of bond-holders in the United States previous to our entrance into the war has been roughly estimated at three hundred and fifty thousand; the subscribers to the first liberty loan at four millions, to the second loan, nine millions, to the third loan, eighteen and a half millions, and to the fourth loan, twenty millions. This increase in the number of bond-holders, and the possibilities of the inculcation of thrift among the masses of people of small incomes which it indicates are pointed to as one of the great indirect benefits of our participation in the World War. If the United States is to maintain the position of prominence which it is now assuming, the participation of the masses of the people, as investors, will be equally necessary now that peace has come. And it is needless to say that if this great development of the investment habit is to be continued and fostered, it must be done, to a large extent, through other than government securities, especially when the war issues of the federal government begin to be redeemed. Hence, the importance of reform making for soundness in security issues. The average man of small income has a clear-cut philosophy to the effect that he prefers to squander his savings himself, rather than have others do it for him, and the enormous financial asset, which is potential in the present development of small holdings, can be realized only through scrupulous attention to the maintenance of confidence.

In the gubernatorial campaign of that year, Mr. Hearst, the Democratic nominee, adopted a platform, the chief plank of which was public ownership of those utilities which in their nature are monopolies. Charles E. Hughes, the nominee of the Republican Party, countered with the contention that real regulative control had never yet been given a fair trial, and promised, if elected, to put through an adequate program of administrative control of public utilities. The narrow margin by which Mr. Hughes was elected indicated the strength of the public ownership plea. Hughes was therefore committed to a thorough-going test of the adequacy of administrative control of public utilities, and immediately upon his assumption of office, he directed and supervised the preparation of what later came to be known as the Public Service Commissions Law, under the terms of which the proposed commissions were to be given sweeping powers over rates, the providing of adequate facilities, and the issuance of securities. The public utilities bill recommended by Governor Hughes was far more comprehensive than the Interstate Commerce Act.

The great difference between the Interstate Commerce Act, and the bill backed by Governor Hughes, was the grant, in the latter act, of power to regulate the issue of stock and bonds.

The bill found strong popular support which was ably led by the Governor. The public service corporations endeavored to amend the bill so as to deprive the proposed commissions of power to execute their own orders and require them to go into court as litigants before their rulings became effective. Finally, owing to the exertions of Governor Hughes, this amendment was confined to the protection of the constitutional rights of public service corporations, just as in the case of all legislation affecting individuals. Against the combined efforts of the political managers of both parties, and of the great corporations that held public franchises in the state, the Public Service Commissions Law was enacted. It became effective July 1, 1907.[2]

[2] Chapter 429—Laws of 1907. The Court of Appeals in the case of *People ex rel. N. Y. Edison Co.* v. *Willcox* (207 N. Y., 93. Decided Dec. 31, 1912.), Mr. Justice Cullen writing the opinion, said:—"That law [Public Service Commissions Law] was enacted in response to a pronounced and insistent public opinion and was a radical and important modification of the relations and policy of the people toward the corporations which are its subjects. Its paramount purpose was to protect and enforce the rights of the public. It made the commissions the guardians of the public by enabling them to prevent the issue of stock and bonds for other than statutory purposes or *in appreciable and unfair excess of the value of the assets securing them* . . . ." (Italics not in original.)

As a demonstration of the triumph of public opinion intelligently led, over what was perhaps the strongest combination of opposing interests that has ever expressed itself at any state capital, the passage of this bill marked an epoch in public utility control.

The control of security issues by regulative bodies is being generally recognized as the basis of utility regulation, and the conferring of such powers upon the Interstate Commerce Commission would, under normal conditions, have been the next step in the federal control of interstate carriers.

As the underlying idea of the enactment of the Public Service Commissions law of New York was to give administrative regulation, based upon control of security issues, a fair test, and, as the size and complexity of the problems which those Commissions had to meet were unusual, a study of the results accomplished by the commissions should be of value. The work is based upon the "reports"[3] of the two Commissions,[4] the "annual report" (statistical) issued by each Commission, upon court decisions, and upon the briefs and exhibits in important cases. Persons familiar with the work of the Commissions have been consulted wherever possible.

The monograph was inspired largely by the deep interest of Dr. Clyde L. King in this kind of regulation, and the writer's thanks are due to him for his helpful guidance in its preparation. Special acknowledgment for valuable advice and suggestions is here made to Hon. Milo R. Maltbie, who was for eight years a member of the Public Service Commission for the First District;[5] also to Hon. Frank W. Stevens, ex-chairman of the Public Service Commission for the Second District.[6] Dr. Delos F.

[3] The form of citation of cases used by the First District Commission consists of the initials of the words, Public Service Commission Reports, or P.S.C.R. To this is prefixed the number of the volume and there is placed after the initials the abbreviation, "1st Dist.," for First District, then, the abbreviation for the State, followed by the page number. A similar form is used by the Second District Commission, except that P. S. C. is used instead of P. S. C. R. thus: 2 P. S. C. 2nd Dist. N. Y. 47.

For the sake of uniformity, citations have been made to conform to those of the First District.

[4] For the purposes of administration of the Public Service Commissions Law, the State of New York is divided into two districts; the First District, comprising the City of Greater New York, and the Second District, which includes the remainder of the state.

[5] Dr. Maltbie was one of the original appointees of Governor Hughes, and at the expiration of his first term was reappointed by Mr. Hughes. He served from July, 1907, until March, 1915.

[6] Mr. Stevens was also an original appointee of Governor Hughes and served as chairman of the Second District Commission from July 1, 1907, to May 2, 1913.

Wilcox, public utility expert, Dr. Louis Roth, former Librarian, First District Commission, and Mr. H. C. Hasbrouck, Chief Statistician, Second District Commission have also rendered assistance. Dr. E. M. Patterson, of the University of Pennsylvania, was kind enough to read the manuscript.

PART ONE

STATUTORY PROVISIONS FOR THE ADMINISTRATIVE REGULATION OF UTILITY CAPITALIZATION IN NEW YORK

CHAPTER I

Administrative Regulation Prior to July 1, 1907

The administrative control of the capitalization of public utility companies which existed in New York State prior to July 1, 1907, the date of the taking effect of the Public Service Commissions Law, accomplished little of real value, and is worthy of attention principally from the point of view of historical development.

Until the year 1905 such regulation existed only with regard to railroads and street railroads. The first semblance of administrative control over the capitalization of railroads appears in what is known as the Railroad Law of 1848.[1] This was the first general act under which railroads could incorporate. Prior to this time charters for proposed roads could be obtained only through special acts of the legislature. This law required every company to submit a yearly report to the State Engineer and Surveyor, and it was stipulated that this report should cover the general condition and operations of the company as they affected its capitalization. The company was required to state the amount of capital stock authorized, and the amount actually paid in; the amounts expended for land, construction, and equipment; the amounts and kinds of indebtedness; amounts due to the company; gross earnings from all sources; amounts paid out for operating expenses and repairs, and the number and amounts of dividends paid.

No uniform system of accounts was stipulated, nor was the State Engineer and Surveyor given power to prescribe such. Evidently such control was purely ministerial in character. This matter of annual reports to the State Engineer and Surveyor constituted practically the only element of administrative control of railroad capitalization until the passage of the act creating the Board of Railroad Commissioners in 1882.[2]

In 1850 there was passed what is commonly referred to as The General Railroad Law, an act much more comprehensive than the act of 1848.[3] The annual report to the State Engineer and Surveyor called for under this act was more extensive in that comparative statistics were required of the current and the preceding year, thus showing changes during the year.

[1] Chapter 140, Laws of 1848.

[2] Chapter 353, Laws of 1882.

[3] Chapter 140, Laws of 1850.

For instance, in addition to giving the amount of capital stock authorized, and the amount subscribed, there was required the amount paid in "as by last report" and "total amount now paid in"; "funded debt by last report," and "total amount now of funded debt"; also floating debt as of preceding and of current year.

This comparative method was a step in advance and was carried through the various items under "Cost of road and equipment," "Doings of the year in transportation and total miles run," "Expenses of maintaining the road or real estate of the corporation," and a statement of cash receipts and payments. Under the heading of "Expenses of maintaining the road or real estate of the corporation," there was required to be stated the cost of repairs and the cost of depreciation for the various items of equipment and way. The report was to cover the year ending September 30, and must be filed by December 1. The reference to the cost of depreciation is of interest as showing that at that time provision for depreciation was recognized as a necessary element of operating expenses.

An amendatory act passed in 1867[4] provided that the section of the act of 1850 regarding the submitting of an annual report by railroad companies should not apply to street or horse railroads, but that every railroad corporation whose road was operated by horse-power exclusively, or by "steam dummy-cars exclusively," or partly by each, should make an annual report to the State Engineer and Surveyor of the year ending September 30, and should file such by December 1 of each year. The items required were given in full in the act and presented a scheme of report similar to that required by the law of 1850.

In 1869 leased companies were relieved from making the annual report required of railroad corporations and the lessor companies were required to make such a report in addition to the report upon their own road.[5]

In 1874 an act was passed "to facilitate the reorganization of railroads sold under mortgage, and providing for the formation of new companies in such cases."[6] Section 1 provided that the purchasers at foreclosure of the property and franchises of a railroad corporation sold under foreclosure, could by the filing of a properly drawn certificate in the office of the Secretary of State, "become a body politic and corporate with all the franchises, rights, powers, privileges and immunities which

[4] Chapter 906, sections 1 and 2, Laws of 1867.

[5] Chapter 844, section 1, Laws of 1869.

[6] Chapter 430, Laws of 1874.

were possessed before such sale by the corporation whose property shall have been sold."

This certificate must contain the name of the new corporation intended to be formed, the maximum amount of its capital stock, and the number of directors of the new company. Consequent upon the due execution of this certificate and the filing of it in the office of the Secretary of State, the purchasers became a corporation with all the powers and privileges and subject to the same liabilities and restrictions as a company formed under the act of 1850.

The requirement that the certificate of reorganization should be filed in the office of the Secretary of State was administrative in theory, but purely ministerial so far as the exercise of any discretionary power was concerned.

By an amendatory act passed in 1876, the reorganization act of 1874 was amended so as to except street railroad companies. A further change provided for the inclusion in the certificate to be filed in the office of the Secretary of State of the plan or agreement of reorganization entered into.[7]

A law of 1878, entitled "An Act to authorize corporations organized under the laws of this state to reduce their capital stock," provided that any corporation might diminish its capital stock to any amount which might be deemed sufficient for the purposes of the corporation with the approval of two-thirds in amount of the stockholders.[8] There must be furnished a certificate of the proceedings, showing the amount of capital actually paid in, the whole amount of debts and liabilities of the company, and the amount to which the capital stock should be diminished. The act further provided that a copy of such certificate should be filed in the office of the Secretary of State *with the approval of the State Comptroller endorsed thereon*,[9] to the effect that the reduced capital was sufficient for the proper purposes of the company, and was in excess of all debts and liabilities of the company exclusive of debts secured by trust mortgages, and that the actual market value of the stock of the company, prior to the reduction of the capital, was less than its par value.

This requirement of approval by the State Comptroller seems to be the first instance of administrative control with discretionary powers,

[7] Chapter 446, section 1, Laws of 1876.

[8] Chapter 264, section 1, Laws of 1878.

[9] Italics not in original.

but any intelligent and effective use of such power would be dependent upon the data available and the means for obtaining it, and there is no record of provision for such.

An act passed in 1880 amended in various particulars the Railroad Law of 1850 and provided, among other things, that increases of capital stock were to be made "with the written approval of the State Engineer and Surveyor, until such time as there shall be appointed a board of railroad commissioners, and after that with the written approval of such board."[10] The issuance of bonds was not included under this restriction.

Another statute enacted in 1880, entitled "An act to facilitate the carrying out of plans and agreements for the reorganization of railroads," provided that whenever the maximum amount of capital stock mentioned in the original certificate of incorporation of any railroad corporation is insufficient to carry a subsequent plan of reorganization, a majority of the directors of the said company may file an additional certificate with the Secretary of State.[11] This certificate should state the additional stock required, and upon the filing of same, with the approval of the State Engineer and Surveyor, the company "shall be authorized to issue such capital stock as fully as if the same had been mentioned or set forth in the original certificate of incorporation." It was further stipulated that such additional certificate should be filed in the office of the Secretary of State within two months after the passage of the act. This would seem to indicate that the measure in question was special legislation, intended for some immediate purpose.

An amendatory act of 1880 changed the act of 1850 as regards the annual report and required a much more elaborate form, comprising about twenty tables.[12] The report, as before, was to cover the year ending September 30, and was to be filed by December 20 with the State Engineer and Surveyor, who, it was further enacted, was to arrange the data in such report in tabular form to be printed for the use of the Legislature.

Board of Railroad Commissioners—1882

In 1882 there was created a board of railroad commissioners to consist of three members appointed by the governor by and with the consent of the Senate.[13] The powers and duties conferred upon the board by

[10] Chapter 133, section 1, Laws of 1880.
[11] Chapter 155, Laws of 1880.
[12] Chapter 575, Laws of 1880.
[13] Chapter 353, Laws of 1882.

this act related to a general supervision of all railroads of the state over their condition and manner of operation as affecting the security and accommodation of the public, the investigation of accidents, and similar matters. The board did not have control of security issues in any real sense. Power to increase capital stock had been conferred upon railroads by the act of 1850.[14] As mentioned above, by an act of 1880,[15] this increase was made subject to the approval of the board of railroad commissioners when appointed.

The board had general power to see that no railroad corporation violated "any constitutional provision or law, or neglects in any respect or particular to comply with the terms of the act by which it was created, or unjustly discriminates in its charges for services, or usurps any authority not by its act of incorporation granted, or refuses to comply with the provisions of any of the laws of the state, or with any recommendation of said board of commissioners.[16]

In case of any violation the Board was to give notice in writing to the corporation so offending, and if the violation or neglect were continued after such notice, it was provided that "the board may forthwith present the fact to the Attorney General, who shall take such proceedings thereon, as may be necessary for the protection of public interests."

From the above it will be seen that the Board was intended to have very limited powers, for, with such roundabout sanction to their rulings, it would be difficult to accomplish any far-reaching results. Section Ten of this act provided that the board should have power to prescribe the form of report required to be made by railroad corporations under the act of 1850; to make changes and additions in such form from time to time, with six months notice to the corporation, and, finally, that the report required by the act of 1850 to be made to the State Engineer and Surveyor should hereafter be made to the Board of Railroad Commissioners.

In May, 1884, a separate General Street Railroad Law was enacted.[17] Heretofore, the provisions of the General Railroad Law had applied to street as well as to steam railroads. This act, however, was "to provide for the construction, extension, maintenance and operation of street surface railroads and branches thereof in cities, towns and villages." This was practically the General Railroad Law of 1850 applied to street surface

[14] Chapter 140, section 9, Laws of 1850.
[15] Chapter 133, section 1, Laws of 1880.
[16] Chapter 353, section 5, Laws of 1882.
[17] Chapter 252, Laws of 1884.

roads, and was much more comprehensive than the law of 1875[18] applying to horse and "steam dummy" railroads.

A repealing act of 1890[19] repealed Chapter 264, Section 1, of the Laws of 1878, previously discussed, which provided for the reduction by a railroad company of its capital stock with the approval of the State Comptroller. The same section also repealed Section 1, Chapter 155, of the Laws of 1880, which required the approval of the Railroad Commission upon any increase in capital stock of a railroad corporation.[20]

In 1890 there was enacted a General Railroad Law which incorporated with various modifications the provisions of the General Railroad Law of 1850 and the provisions of the General Street Railroad Law of 1884.[21] Section 57 provided that "every railroad corporation in this state, or its lessees . . . shall make an annual report to the board of railroad commissioners, according to the form prescribed by such commissioners." This report was to cover the year ending September 30th, and must be filed in the office of the board by December 20th, "except street surface railroads and elevated railways, whose report shall be filed on or before December first." It was further provided that "every such corporation shall make quarterly and further reports to such board in the form and within the time prescribed by it."

In 1892 an amendatory act to the law of 1890 was passed which was substantially a reenactment of that law, with some changes and additions.[22] While the Railroad Law of 1890 is commonly referred to, it is the amended act of 1892 that is generally meant. Section 57 of the act of 1892 required that every person or corporation owning, leasing, operating, or in possession of a railroad wholly or partly in the state should make an annual report to the Railroad Commission of its operations for the year ending June 30th, and should file the same by September 1st of each year. This act repeated the requirement of the previous act that every such corporation should make quarterly and further reports in the form and within the time prescribed by the Commission.

The law of 1890 had prohibited the merger of parallel lines.[23] The

[18] Chapter 446, Laws of 1875.

[19] Chapter 564, section 70, Laws of 1890.

[20] This provision was reenacted in 1899, chapter 426, section 1, Laws of 1899.

[21] Chapter 565, Laws of 1890.

[22] Chapter 676, Laws of 1892.

[23] Chapter 565, section 80, Laws of 1890 had provided that "no railroad corporations owning or operating railroads, whose roads run on parallel or competing lines, shall merge or consolidate, or enter into any contract for the use of their respective roads, or lease the same the one to the other."

act of 1892 gave the Board of Railroad Commissioners power to regulate the merger or consolidation of railroad corporations, other than street surface railroads, in the following language:

no railroad corporation or corporation owning or operating railroads whose roads run on parallel or competing lines, except street surface railroad corporations, shall merge or consolidate, or enter into any contract for the use of their respective roads, or lease the same the one to the other, unless the board of railroad commissioners of the state or a majority of such board shall consent thereto.[24]

In the Railroad Law of 1850, railroad corporations had been empowered to borrow money and issue bonds, and to mortgage their corporate property and franchises.[25] This provision had been omitted from the Railroad Law of 1890,[26] but had been restored in the amended Railroad Law of 1892.[27] By an act of 1899[28] this provision was amended so as to provide that no mortgages, except purchase-money mortgages, should be issued without the consent of the board of railroad commissioners and the consent of stockholders owning at least two-thirds of the stock of the corporation.

Commission of Gas and Electricity—1905

In 1905 an act was passed entitled, "An act to establish a commission of gas and electricity with power to regulate the price of gas and electric light and certain other electric services, and to provide for the control and supervision of gas, electric light and other electric corporations . . . "[29] This law provided for the appointment of three commissioners by the governor, by and with the consent of the senate. They were to receive salaries of eight thousand dollars a year.

In the matter of security control the commission was given powers over the approval of issues of stocks and bonds, of stock transfers, and of consolidation and mergers. Administrative control of the securities of gas and electrical corporations did not exist prior to 1905, up to which time such companies had incorporated under the Transportation Companies Act,[30] sections 62, 63 and 64, which contained no provision for administrative control of capitalization, except a requirement for the formal filing of the certificate of incorporation with the Secretary of

[24] Chapter 676, section 80, Laws of 1892.
[25] Chapter 140, Laws of 1850.
[26] Chapter 565, Laws of 1890.
[27] Chapter 676, Laws of 1892.
[28] Chapter 583, section 1, Laws of 1899.
[29] Chapter 737, Laws of 1905.
[30] Laws of 1890, Chapter 566.

State. Section 128 of the Gas and Electric Commission Act of 1905, on the other hand, provided that stock or bonds were not to be issued by any gas or electrical corporation "*hereinafter* incorporated" until a certificate of authority should have been issued "and until such commission shall further certify in writing as to the amount of stock or bonds "*reasonably required*" for the purposes of the corporation," and it was further provided that the corporation should not issue securities in excess of the amount certified. So much for security-issues of original companies; as to additional capitalization for existing companies, it was similarly provided that any such corporation "*heretofore* or *hereafter* incorporated"[31] should not increase its capital stock or its bonded indebtedness without the consent in writing of the commission, which consent should state the amount of the increase.[32] This law required that the Commission of Gas and Electricity should make its determination as to the issue of securities within thirty days after the final hearing. The Public Service Commissions Act contains no such requirement.

This act of 1905 seems to draw a distinction between cases of petitions for approval of capitalization for original companies and petitions for additional capitalization for existing companies, whereas the Public Service Commissions Act makes no such distinction, and provides[33] for

[31] Italics not in original.

[32] In contrast with these provisions of the Gas and Electric Commission Act of 1905, the Public Service Commissions Act provides for an exception in the matter of short-term notes, as follows (section 69, Chapter 429, Laws of 1907): "Such Gas corporation or electrical corporation may issue notes, for proper corporate purposes and not in violation of any provision of this or of any other act, payable at *periods of not more than twelve months* without such consent; but no such notes shall, in whole or in part, directly or indirectly be refunded by any issue of stock or bonds or by any evidence of indebtedness running for more than twelve months *without* the consent of the proper commission."

[33] As the Public Service Commissions Law was originally drafted in 1907, the Commissions were required, in granting approval of proposed security-issues, to state in their Order that the use of the capital involved was necessary for one of four stipulated purposes. Section 69 provided as follows: "A gas corporation or electrical corporation organized or existing, or hereafter incorporated, under or by virtue of the laws of the state of New York, may issue stocks, bonds, notes or other evidence of indebtedness payable at periods of more than twelve months after the date thereof when necessary for the acquisition of property, the construction, extension or improvement of its plant or distributing system, or for the improvement or maintenance of its service, or for the discharge or lawful refunding of its obligations, provided and not otherwise, that there shall have been secured from the proper commission an order authorizing such issue, and the amount thereof, and stating that, in the opinion of the commission, the use of

approval of securities for "a gas corporation or electrical corporation organized or existing, or hereafter incorporated."

The 1905 act provided that for the purpose of determining upon the amount of securities to be issued, the commission might take testimony, examine the books and papers of the corporation and require verified statements from the officers of the corporation "pertaining to the value of the property *and franchises* owned and operated by such corporation." While this language does not necessarily sanction the capitalization of franchises, the Public Service Commissions Law, on the other hand, expressly forbade the capitalization of franchises.

As to approval of stock transfers, section 13 of the act of 1905 provided as follows: "no such corporation (gas or electrical) shall directly or indirectly acquire the stock or bonds of any other corporation incorporated for, or engaged in, the same or a similar business, or proposing to operate or operating under a franchise from the same or any other municipality, unless authorized to do so by the Commission."[34] This act did not give the Commission of Gas and Electricity any specific powers in restricting the amounts of securities to be issued in the cases of consolidations and mergers, while the Public Service Commissions Law (1907) did limit the amount of capital stock to be issued in such

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the capital to be secured by the issue of such stock, bonds, notes or other evidence of indebtedness is reasonably required for the said purposes of the corporation."

This provision was amended in 1910, as discussed in connection with the Public Service Commissions Law in following pages.

[34] The corresponding provision of the Public Service Commissions Law, as enacted in 1907, was substantially the same except for the added restriction that no corporation other than a gas or electrical corporation could hold more than ten per cent of the capital of such a corporation. This provision is as follows (section 70): "No such corporation shall directly or indirectly acquire the stock or bonds of any other corporation incorporated for, or engaged in, the same or a similar business, or proposing to operate or operating under a franchise from the same or any other municipality, unless authorized so to do by the commission. Save where stock shall be transferred or held for the purpose of collateral security only with the consent of the commission empowered by this act to give such consent, no stock corporation of any description, domestic or foreign, other than a gas or electrical corporation, shall purchase or acquire, take or hold, more than ten per centum of the total capital stock issued by any gas corporation or electrical corporation, organized or existing under or by virtue of the laws of this state. . . ." This provision was later amended, as discussed in connection with the Public Service Commissions Law, page 14.

cases to the sum of the capital stock (par value) of the corporations consolidated, plus any additional cash contributed.[35]

[35] See Public Service Commissions Law, section 69 (Chapter 429, Laws of 1907), which provides as follows: "Nor shall the capital stock of a corporation formed by the merger or consolidation of two or more corporations exceed the sum of the capital stock of the corporations, so consolidated, at the par value thereof, or such sum and any additional sum actually paid in cash; nor shall any contract for consolidation or lease be capitalized in the stock of any corporation whatever; nor shall any corporation hereafter issue ("*issued*" in original) any bonds against or as a lien upon any contract for consolidation or merger."

In an important consolidation case coming before the Public Service Commission for the Second District, the Commission held that bonded indebtedness was included within the meaning of "capital stock" in the provision just quoted. See page M.

CHAPTER II

THE PUBLIC SERVICE COMMISSIONS LAW, 1907

The Public Service Commissions Law[1] went into effect July 1, 1907. The Public Service Commissions created by it took the places both of the Board of Railroad Commissioners and the Commission of Gas and Electricity, and enjoyed vastly increased powers over those exercised by the administrative bodies to which they succeeded.[2] The act as originally drafted gave the Commissions jurisdiction over two groups of public utility corporations: railroads, street railroads and common carriers, and gas and electric corporations. In 1910, jurisdiction over telegraphs and telephones was added,[3] and in 1913, steam corporations were included.[4]

The sections of the law dealing with control over securities were substantially amended in 1910.[5] As originally passed, the act provided that a corporation under the jurisdiction of the commissions could issue stocks, bonds, notes or other evidences of indebtedness running for more than twelve months, when necessary for four purposes, as follows:

> "the acquisition of property,
>
> "the construction, extension or improvement of its plant or distributing system, or
>
> "for the improvement or maintenance of its service, or[6]
>
> "for the discharge or lawful refunding of its obligations, . . . "

It was found, subsequently, that these stipulated purposes would not allow a corporation to reimburse its treasury for expenditures made from income, although these expenditures might have been made for one of the purposes enumerated in the statute. To remedy this defect the law was amended[7] in 1910, by adding a fifth purpose for which securities could be issued, as follows:

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[1] Chapter 429, Laws of 1907.

[2] These two commissions were abolished, and all powers and duties conferred and imposed by any existing statutes were to be exercised and performed by the public service commissions. The same applied to the offices of inspector and deputy inspectors of gas meters, and to the board of rapid transit railroad commissioners. The last two named bodies had no powers in matters of capitalization.

[3] Chapter 673, Laws of 1910.

[4] Chapter 505, Laws of 1913.

[5] Chapter 481, Laws of 1910.

[6] Public Service Commissions Law, sections 55, 69, 82 and 101.

[7] Chapter 481, Laws of 1910.

"or for the reimbursement of moneys actually expended from income or from any other moneys in the treasury of the corporation not secured by or obtained from the issue of stocks, bonds, notes or other evidence of indebtedness of such corporation, within five years next prior to the filing of an application with the proper commission for the required authorization, for any of the aforesaid purposes except maintenance of service and except replacements in cases where the applicant shall have kept its accounts and vouchers of such expenditure in such manner as to enable the commission to ascertain the amount of moneys so expended and the purposes for which such expenditure was made."

The act of 1907 stipulated that securities were to be issued for the purposes named "provided and not otherwise that there shall have been obtained from the proper commission an order authorizing such issue, and the amount thereof and stating (the purposes to which the issue or proceeds thereof are to be applied, and) that, in the opinion of the commission [the use of the capital to be secured] by the issue of such stock, bonds, notes or other evidence of indebtedness is (or has been) reasonably required for the [said purposes of the corporation."] The two enclosures in parentheses were *added* in 1910[8] while at the same time, the two enclosures in brackets were *changed* as follows: the phrase, "the use of the capital to be secured" was changed to "the money, property or labor to be procured or paid for," while the phrase "for the said purposes of the corporation" was altered to read "for the purposes specified in the order." At this point there was also added in 1910 the following clause: "and that except as otherwise permitted in the order in the case of bonds, notes and other evidence of indebtedness, such purposes are not, in whole or in part, reasonably chargeable to operating expenses or to income; . . . " The object here sought was, apparently, to prevent the commissions' permitting a corporation to issue stock for purposes properly chargeable to operating expenses or income in those cases of emergency where it might see fit to exercise the discretionary powers granted to it in permitting the funding of such expenditures. Funding in such cases should, of course, be made as temporary as possible, and it would be much easier to insure rapid amortization in the case of bonds or notes than in the case of stock. It was provided, however, that this should not apply to securities issued prior to the taking effect of the Public Service Commissions Law.

In 1910 there was also added a clause which apparently gave to the commissions discretion in the matter of allowing a corporation to reimburse its treasury in cases where the records were missing. This clause read as follows:

[8] See ref., preceding footnote.

Nothing herein contained shall prohibit the commission from giving its consent to the issue of bonds, notes, or other evidences of indebtedness for the reimbursement of moneys heretofore actually expended from income for any of the aforesaid purposes, except maintenance of service and replacements, prior to five years next preceding the filing of an application therefor, if in the judgment of the Commission such consent should be granted; provided application for such consent shall be made prior to January first, nineteen hundred and twelve.

This clause was evidently intended to cover cases of alleged expenditure where accounts and vouchers were not available, but where the Commission might nevertheless feel convinced that a corporation had made expenditures for proper capital purposes. The time limit of January first, 1912, gave corporations fair warning that in future complete records and vouchers must be available if the approval of securities to reimburse the treasury were to be allowed by the Commission. Five years prior to January 1, 1912, the time limit of the discretion allowed the commissions in this regard, would be January 1, 1907, or six months prior to the taking effect of the Public Service Commissions Law.

The original act provided for thorough investigation of proposed issues: "for the purpose of enabling it to determine whether it should issue such an order, the Commission shall make such inquiry or investigation, hold such hearings and examine such witnesses, books, papers, documents or contracts as it may deem of importance in enabling it to reach a determination."

In 1910 there was here added a restriction upon the use of the proceeds to the effect that "such corporation shall not without the consent of the commission apply said issue or any proceeds thereof to any purpose not specified in such order." The Commissions in actual practice allow additional elasticity in expenditure where they deem it necessary. It was provided[9] that notes for "proper corporate purposes and not in violation of any provision of this chapter or any other act" could be issued for periods of not more than twelve months without the consent of the commissions, but was further provided that no such notes should be refunded into stock, bonds, or other evidence of indebtedness running for more than twelve months, "in whole or in part, directly or indirectly," without the consent of the proper commission.

The same sections expressly forbid the commissions to authorize the capitalizations of franchises,[10] and also restrict the commissions' approval

[9] See sections 55, 69, 82, 101.

[10] Sections 55, 69, 82, 101; as to capitalization of franchises it is provided that the commissions "shall have no power to authorize the capitalization of any franchise to be a corporation or to authorize the capitalization of any franchise or the right to own, operate or enjoy any franchise whatsoever in excess of the amount (exclusive of any tax or annual charge) actually paid to the state or to a political subdivision thereof as the consideration for the grant of such franchise or right; . . ."

of the amount of capital stock of a corporation formed by merger or consolidation to a maximum of the sum of the capital stock of the corporations so consolidated.[11]

The act of 1907,[12] the original Public Service Commissions Law, made all transfers of franchises or stock subject to the approval of the Commissions.[13]

Stock transfers were restricted by the same section as follows:

> No railroad corporation, street railroad corporation (or electrical corporation), domestic or foreign, shall hereafter purchase or acquire, take or hold, any part of the capital stock of any railroad corporation or street railroad corporation or other common carrier organized or existing under or by virtue of the laws of this state, unless authorized so to do by the commission empowered by this act to give such consent; and save where stock shall be transferred or held for the purpose of collateral security only with the consent of the commission empowered by this chapter to give such consent, no stock corporation of any description, domestic or foreign, other than a railroad corporation, street railroad corporation, (or electrical corporation) shall purchase or acquire, take, or hold, more than ten per centum of the total capital stock issued by any railroad corporation or street railroad corporation or other common carrier organized or existing under or by virtue of the laws of this state.[14]

All corporations subject to the Public Service Commissions are required to file an annual report. The commissions are given power to

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[11] Restriction of the amount of capital stock to be issued by a corporation resulting from merger or consolidation was provided for as follows (see same sections of the law as above): "Nor shall the capital stock of a corporation formed by the merger or consolidation of two or more other corporations, exceed the sum of the capital stock of the corporations so consolidated, at the par value thereof, or such sum and any additional sum actually paid in cash; nor shall any contract for consolidation or lease be capitalized in the stock of any corporation whatever; nor shall any corporation hereafter issue any bonds against or as a lien upon any contract for consolidation or merger."

[12] Chapter 429, Laws for 1907.

[13] Section 54 provided as follows: "No franchise nor any right to or under any franchise, to own or operate a railroad or street railroad shall be assigned, transferred or leased, nor shall any contract or agreement with reference to affecting any such franchise or right be valid or of any force or effect whatsoever, unless the assignment, transfer, lease, contract or agreement shall have been approved by the proper commission. The permission and approval of the commission . . . shall not be construed to revive or validate any lapsed or invalid franchise, or to enlarge or add to the powers and privileges contained in the grant of any franchise, or to waive any forfeiture."

See also sections 70, 83, and 100, for similar sections dealing with gas and electric, steam, and telegraph and telephone corporations, respectively.

[14] At this point there was added in 1911 (Ch. 788, Sec. 1, Laws of 1911), the following clause: "except that a corporation now lawfully holding a majority of the capital stock of any railroad corporation or street railroad corporation may with the

prescribe the forms of reports,[15] and must furnish corporations under their jurisdiction with such blank forms on or before June 30th. The report must be filed by September 30th in the case of railroads and street railways, and in the cases of the other classes of corporations the fixing of dates is left to the discretion of the Commissions.

The General Railroad Law of 1910

In 1910 various changes were made in the General Railroad Law as enacted in 1890,[16] and amended in 1892,[17] and the law as thus amended constitutes the General Railroad Law as now in force.[18]

Under an act of 1909, it had been made illegal to consolidate a tunnel or subsurface railroad exceeding five miles in length.[19] In 1910 this restriction was removed.[20]

Section 155 provided that the consolidation of a domestic railroad corporation with a foreign railroad corporation, effected prior to March 10, 1903, should not be deemed invalid because such roads at the time of the consolidation did not form a continuous and connected line, if, when the consolidation was effected, or thereafter, an intermediate line, by purchase or by lease of not less than 99 years, became, with the consolidated roads, a continuous and connecting line of railroad. Section 141, subdivision 1, of the law of 1910 provides that the capital stock of such a consolidated corporation shall not exceed the sum of the capital stock of the corporations so consolidated at par, and that no bonds or

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consent of the commission acquire and hold the remainder of the capital stock of such railroad corporation or street railroad corporation or any portion thereof."

The original act further provides, as follows: "Nothing herein contained shall be construed to prevent the holding of stock heretofore lawfully acquired," to which was likewise added in 1911 (Ch. 788, Sec. 1 as above) the following: "or to prevent, upon the surrender or exchange of said stock pursuant to a reorganization plan, the purchase, acquisition, taking or holding of a proportionate amount of stock of any new corporation organized to take over, at foreclosure or other sale, the property of any corporation whose stock has thus been surrendered or exchanged, or, subject to approval by the commission, of any further issue of stock provided such further issue does not increase the proportion of stock held by such stock corporation."

[15] Chapter 429, Laws of 1907, sections 46, 66, 80 and 95.

[16] Chapter 565, Laws of 1890.

[17] Chapter 676, Laws of 1892.

[18] Chapter 481, Laws of 1910.

[19] Chapter 564, section 1, Laws of 1909.

[20] Chapter 481, section 140, Laws of 1910.

other evidences of debt shall be issued as a consideration for or in connection with such a consolidation.[21]

Merger of lessor companies, as provided for in the railroad law of 1890,[22] was made subject to approval of the proper commission.[23] Under the law of 1890,[24] railroad corporations owning or operating competing lines were forbidden to merge or consolidate, but in 1892 street railways had been excepted, and the consolidation or merger of other railroads with competing lines was made subject to the board of railroad commissioners.[25] In 1910 such action was made subject to the consent of the proper commission.[26]

Permission for a railroad corporation to contract with another railroad corporation for the use of its road, as provided in the law of 1890[27] and permission to exchange or guarantee securities,[28] were made subject to the approval of the proper commission in 1910.[29]It had been provided in 1899 that no railroad corporation should issue mortgages, except purchase-money mortgages, without the consent of the board of railroad commissioners.[30] This was now made subject to the consent of the Public Service Commissions.[31]

The Public Service Commissions Law as enacted in 1907 formed chapter 429, Laws of 1907. As amended and reenacted in 1910, it is known as Chapter 480, Laws of 1910, and constitutes Chapter Forty-Eight of the Consolidated Laws.

The Public Service Commissions Law, as reenacted in 1910, was amended in 1912.[32] The amendment applied exclusively to reorganizations and sought to give the commissions specific powers which would place their jurisdiction in such cases beyond dispute. This amendment was added to the various sections of the Public Service Commissions Law which governed the issue of securities. It consisted of two sections, the

[21] See chapter 565, section 71, subd. 1, Laws of 1890.
[22] Chapter 565, section 79, Laws of 1890.
[23] Chapter 481, section 149, Laws of 1910.
[24] Chapter 565, section 80, Laws of 1890.
[25] Chapter 676, section 80, Laws of 1892.
[26] Chapter 481, section 150, Laws of 1910.
[27] Chapter 565, section 78, Laws of 1890.
[28] Chapter 676, section 78, Laws of 1892.
[29] Chapter 481, section 148, Laws of 1910.
[30] Chapter 583, section 1, Laws of 1899.
[31] Chapter 481, section 8, subd. 10, Laws of 1910.
[32] Chapter 289, section 1, Laws of 1912. Sections 55, 69, 82, and 101 each had this amendment added to them as 55a, 69a, 82a, and 101a, respectively.

first of which provided that reorganizations of utility corporations belonging to the classes of utilities subject to the jurisdiction of the commissions, which reorganizations had been made pursuant to sections nine and ten of the stock corporation law or any other laws subsequently enacted, should be "subject to the supervision and control of the proper commission and no such reorganization shall be had without the authorization of such commission."

In reorganization cases prior to this time (1912), notably in the Third Avenue case, the jurisdiction of the commissions had been challenged, and their powers to base the amount of securities to be issued pursuant to a reorganization upon the value of the property had been denied. The courts had been unwilling to support the commissions upon this issue on the ground that the Public Service Commissions Law, as originally enacted in 1907, did not give the commissions specific powers in such cases, while the pre-existing reorganization law (sections nine and ten of the stock corporation law) did give corporations specific powers. Section Two of the 1912 amendment, discussed above, aimed to give to the commissions the specific powers which they lacked.[23]

[23] Section 2, chapter 289, Laws of 1912, incorporated under sections 55a, 69a, 82a, and 101a, of the Public Service Commissions Law, provided as follows: "Upon all such reorganizations the amount of capitalization, including therein all stocks and bonds and other evidence of indebtedness, shall be such as is authorized by the commission which in making its determination shall not exceed the fair value of the property involved, taking into consideration its original cost of construction, duplication cost, present condition, earning power at reasonable rates and all other relevant matters and any additional sum or sums as shall be actually paid in cash, provided, however, that the commission may make due allowance for discount of bonds. Any reorganization agreement before it becomes effective shall be amended so that the amount of capitalization shall conform to the amount authorized by the Commission."

PART TWO
ORIGINAL COMPANIES
CHAPTER III
Amount of Capitalization Permissible

The applications of new companies constitute the simplest class of cases involving approval of security issues. Some of the cases included were not original in that the applicant had no outstanding capitalization, but the existing amounts of the latter were relatively small and in the principles involved such cases fall within this category.

The principal questions considered have been the amount of capitalization which could properly be permitted, and the relative proportion of stock to bonds. The amount of capitalization can be but approximate because of the contingencies met with in construction work, and the fluctuating prices of materials.

In fixing the proportion of stock to bonds the object is to control any tendency toward what is popularly known as 'wild-catting,' that is, the promotion of enterprises upon such meagre capital as to render them largely speculative. The object is also to compel promoters of an enterprise to furnish sufficient capital to provide a moral guaranty of their faith in its financial success. This is necessary for two reasons; to give conservative investors, that is prospective bondholders, a reasonable protection against the annoyance and loss attendant upon foreclosure proceedings, and, also, to save the consumers of public utility corporations from the interruptions of service consequent upon default of bond interest and change of control.

To insure the practical execution of their policies the Commissions impose stringent requirements in the carrying out of the work involved, such as the auditing by the Commission's accountants of the vouchers for the various items of expenditure, frequent reports to the Commission by the corporation, inspections of the progress of the work by the engineering staff of the Commission, and, of especial importance, provisions for the amortization of bond-discount, and for setting aside reserves to meet depreciation of the physical property.

The practice of awarding contracts for construction work to so-called "construction companies," organized and managed by individuals prominent in the management of the corporation itself, has been condemned by the New York Commissions as a subterfuge for the payment of unwarranted profits to the individuals interested.[1]

[1] " . . . Interior construction companies, a device which will at all times receive the condemnation of this Commission so far as it has any power or jurisdiction in

Actual cost has been recognized by both commissions as the proper basis for capitalization; cost-of-reproduction-new has been relied upon only in cases where the records of original cost were not available, and then merely as one of several means of arriving at a determination.

A hard and fast program of expenditures often proves inexpedient for the best interests of the corporation. This is due to rapidly changing needs, improvements in machinery, and similar reasons. The necessary elasticity in the expenditure of proceeds of securities has been provided by an arrangement which has proved mutually satisfactory to the Commissions and to the corporations. Under this arrangement the corporation is free to use its judgment as to the specific item of expenditure, as, for instance, whether it shall purchase a new boiler or a new generator. Each item of outlay, however, will be subject to the approval of the respective Commission before it can be charged to capital account. Thus the corporation knows beforehand that any items not properly chargeable to capital will have to be met from current income.

Tangible Elements of Cost

One of the first cases involving a large amount of new construction to come up in New York State after the enactment of the Public Service Commissions Law was that of the Rochester Corning Elmira Traction Company,[2] referred to hereafter as the Rochester Corning case. This company had been granted a certificate of public convenience and necessity by the Board of Railroad Commissioners[3] upon March 22, 1907. The capital stock authorized by the articles of association consisted of 40,000 shares of common stock of $100 par value, or a total of $4,000,000. Of this $120,000 had been issued, leaving $3,880,000 unissued. The applicant now asked for authorization to issue the remaining $3,880,000 stock; also for the execution of a mortgage upon its property to secure bonds to the amount of $8,000,000 and authority to issue bonds to this amount.

the matter." (Matter of application of the Rochester Corning Elmira Traction Company. 1 P.S.C.R. 2nd Dist. N. Y. 166. Decided March 30, 1908. See top of page 189). "The Commission does not favor the formation of a construction company by the persons who control the corporation with which such construction company is to do business." (Matter of application of the New York and North Shore Traction Company. 3 P.S.C.R. 1st Dist. N. Y. 63. Opinion adopted February 13, 1912. See page 80).

[2] Matter of application of the Rochester Corning Elmira Traction Company, 1 P.S.C.R. 2nd Dist. N. Y., 166. Decided March 30, 1908.

[3] The Board of Railroad Commissioners was created in 1882 and expired automatically with the installation of the Public Service Commissions, July 1, 1907.

The questions involved in the proposed issue of securities were the amount of capitalization which should be permitted, how the capitalization should be distributed between stock and bonds, and how the construction of the road should be secured in accordance with the plans upon which the capitalization should be authorized. It seemed necessary to lay down principles which should govern the capitalization of new railroad corporations in order to carry out both the spirit and the letter of the Public Service Commissions Law.

The Commission felt that it could not certify that any particular amount of capital was reasonably required for the purposes of a corporation without a careful and exhaustive inquiry into the cost of the property proposed to be acquired and of the facilities proposed to be constructed.

In this case it was held that it was impossible to arrive at any definite amount of capitalization to be permitted, and the Commission stated that the best they could do was not to allow too much; that in view of the rapid and often extreme fluctuations in unit prices, as, for instance, in the case of copper, accuracy was impossible and estimates could be approximate only. It was better, however, the Commission felt, "to err upon the side of allowing too little rather than too much," as additional authorizations of capital could easily be arranged for whenever they were shown to be necessary.

An order approving capitalization for a new enterprise, the Commission held, should be elastic enough to provide for additional amounts of capital, if such were necessary, but such elasticity, it was pointed out, should be so hedged about with restrictions that it would be impossible for a company to secure more capital than was necessary for the purposes contemplated by the Commission in granting such authorization.

A similar case—similar in that the Commission had to feel its way—was that of the New York and Ontario Power Company.[4] The applicant desired to construct a hydro-electric plant and distributing system at Waddington, on the St. Lawrence River. Application was made for authority to issue $1,850,000 of first mortgage 5 per cent bonds, which it was proposed to sell at 80 and to issue capital stock to the amount of $640,000. The proceeds of securities were to be invested in the development and improvement of its water power property. Bonds and stock, each to the amount of $150,000 were already outstanding, having been

[4] Matter of application of the New York and Ontario Power Company, 1 P.S.C.R. 2nd Dist. N. Y. 453. Decided January 14, 1909.

authorized by the former Commission of Gas and Electricity.[5] Said the commission:

It is obvious that in work of this character a preliminary estimate is not and cannot be accurate, contingencies in an undertaking of this kind are very great, unit prices may vary considerably during the progress of the work, unforeseen difficulties may be encountered, and delays and accidents may impede the progress of the work from time to time. Because of these and other reasons it is impossible to know what a work of this extensive character will actually cost. It is only possible for this Commission, as well as for the projectors of the scheme to say that the work will cost approximately a certain sum.

As a result of a detailed examination by its electrical engineer of the various items in the estimates submitted, the Commission made a comparatively slight reduction in the proposed amount of capitalization.

Other features of the proposed plan which the Commission considered, were the commercial feasibility of the scheme, the amount of power which could be developed, the probable gross income, operating expenses, taxes and depreciation.

As to the ratio upon which the capitalization was to be divided between stock and bonds, the Commission seemed inclined to accept the proportion proposed by the applicant, mainly, it seemed, because the latter presented proof that the bonds could readily be disposed of. If sold at 80 the yield upon the bonds would be about 6.5 per cent. The Commission held that for a new enterprise of this character this was not an unreasonable return.

In selling bonds at 80 there would be a bond discount of 20 per cent to be amortized during the life of the bonds. It might be noted in passing that the amortization of bond discount is provided for in the Uniform Systems of Accounts prescribed by the Commissions (1908),[6] and is required as a matter of course in all Orders permitting issues of bonds.

The authorization was finally made to the following effect: That stock might be issued to the amount of $600,000, to be sold for cash only at the full par value.[7] In case it was found desirable to dispose of said stock for property, further application should be made to the Commission, to the end that upon such application full inquiry might be made as to the value of the property. Sales of stock should be reported from

[5] The Commission of Gas and Electricity was created by the New York Legislature in 1905, and like the Board of Railroad Commissioners it expired automatically with the installation of the Public Service Commissions, July 1, 1907.

[6] See 1 P.S.C.R. 2nd Dist. N. Y. bottom page 455. These systems took effect January 1, 1909.

[7] See Stock Corporations Law, Laws of 1892, Section 688.

time to time as made, giving full details of the transaction, including name of purchaser, amount sold, and amount realized; bonds might be issued to the par value of $1,850,000 and must be disposed of at a minimum of 81, instead of 80, as proposed. A report was required of each and every sale of bonds when made, with a full statement of the distribution of the proceeds. Every six months during the progress of the work reports were to be made of the expenditure of the money.

It is hardly necessary to point out the practical difficulties which confront a regulating body in estimating the proper amount of securities in a case of this kind. Its powers may be adequate, but the information obtainable is not. Hence approximate results are all that can be achieved. The accumulation of experience and data will, of course, afford a basis for more accurate approximations as time goes on.

Intangible Elements of Cost

In addition to the cost of the tangible property, there are many intangible elements necessarily attendant upon bringing into existence a new utility enterprise. Those regarded by the Commissions as being most commonly recognized were enumerated as follows:[8]

(1) expense of organization, (2) incorporation tax, (3) expense of obtaining a certificate of public convenience and necessity, (4) preliminary engineering expenses, (5) expense of procuring the authorization of issue of stock and bonds, (6) expense of marketing the securities, (7) discount upon the bonds provided they can not be sold at par, (8) interest upon the bond issue during the period of construction and prior to the beginning of operations, (9) compensation of officers of the road during the construction period, (10) incidental expenses during construction period, (11) expense of obtaining local franchises and consents.

Interest During Construction Period

In connection with the application of the New York and North Shore Traction Company, hereafter referred to as the North Shore case, the First District Commission, in its investigation and discussion of the building of the original portion of the property, held that the construction period ended when operation began and that thereafter it was not proper to charge interest upon cost to capital account, but to pay it from earnings.[9] The company contended that it should be allowed to capitalize interest and operating expenses for some six months after the full system had been put into operation, because the property was in an experimental

[8] Rochester Corning case 1 P.S.C.R. 2nd Dist. N. Y. 166. See page 176.

[9] Matter of application of the New York and North Shore Traction Company. 3 P.S.C.R. N.Y. 63. Opinion adopted February 13, 1912. The ends of the construction periods of the various parts of the road in the North Shore case were taken by the

stage. The Commission reasoned that an operating property never really got out of the experimental stage and that if such a principle were once granted it would open the way to abuse owing to the difficulty in drawing any line as to when the initial experimental stage had ceased. It was suggested that a proper solution would be

> To charge all current expenses incurred after public operation begins to income account, and later, when receipts will permit, to distribute a sufficient amount in dividends to equal a fair return not merely for the current years, but for the early years when profits were lacking.[10]

Working Capital

In addition to these elements, it was held in the Rochester Corning case that a "reasonable amount" of working capital was necessary at the beginning of operations. It might be noted here that in the North Shore case, just referred to, $150,000 was asked for working capital out of a proposed capitalization of $2,272,000. This amount was reduced by the First District Commission to $10,000, pending further proof of necessity. In England working capital is not considered a proper item of capitalization.

Promoters Fees

In the Rochester Corning case consideration was also given to the allowance of financial recognition for the services of promoters. The propriety of compensation for actual services rendered was assumed, but the difficulty, the Commission felt, lay in finding a method of arriving at a definite amount. A tentative suggestion was made to the effect that a percentage be allowed upon the cost of an enterprise, the percentage depending upon the merits of the individual case. The Commission said in discussing this case:[10]

> It should be clearly recognized that the system of capitalization of entirely new enterprises required by the Public Service Commissions Law is such an innovation upon established practices which have been found to be replete with injury to the public that some time and experience must be required to work out a completely satisfactory method of administration.[11]

Another instance of compensation to promoters came up in the dis-

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Commission as February 1, 1908; March 1, 1909; and November 1, 1910. Up to March 1, 1912, the company had been unable to pay bond charges, and the Commission stated that in its opinion it would be but fair, if future earnings should warrant, that dividends should be paid to the stockholders from the dates of the endings of the respective construction periods to March 1, 1912.

[10] See 3 P.S.C.R. 1st Dist. N.Y. middle page 85.

[11] See 1 P.S.C.R. 2nd Dist. N. Y. page 178. Matter of application of Rochester Corning Elmira Traction Company.

cussion by the Second District Commission of an application of the Hudson River and Eastern Traction Company for approval of security issues.[12] Authorization was sought, among other things, for the issue of $50,000 of stock to a certain individual, one F. A. Stratton, in settlement of claims for "services rendered in the promotion of the enterprise and in procuring franchises and rights of way." It was held by the Commission that the proof submitted was not sufficient to show the extent of the services, or their value, and that while Mr. Stratton was entitled to remuneration for services rendered he did not seem to be entitled to any such sum. The application for the $50,000 was therefore denied pending further proof, if the applicant chose to offer such.

Percentage Paid to Interior Construction Companies Disapproved

The matter of the Application of the New York and North Shore Traction Company[13] was technically a refunding case but the important factors of the decision are germane to the consideration of original companies. Chief among them is the matter of 'interior construction' companies. Prior to July 1, 1907, the date of the assumption of control by the Public Service Commissions, the applicant had received authority to issue stock to the amount of $1,250,000 and bonds to the amount of $1,000,000. The original line had been built by a corporation known as the Cleveland Construction Company. Funds for construction had been advanced to the latter by the New York and Nassau County Railway Syndicate, composed of persons controlling the traction company. The aforesaid railway syndicate had in turn received from the traction company, its *alter ego*, $117,000, par value, of capital stock and $350,000, par value, of first mortgage bonds. These securities had been transferred by the construction company to two individuals, Stanley and MacElhinney, acting in the capacity of trustees.

Other divisions of the property had been built under a contract between the Railway Syndicate and a different construction company, different in name at least, the New York and Nassau Construction Company. The same method was pursued, the railway syndicate advancing funds to the construction company, and receiving in turn 6 per cent notes from the traction company, issued as follows: For construction $1,224,612; interest on construction expenditures, $89,700;

[12] Matter of application of the Hudson River and Eastern Traction Company, 3 P.S.C.R. 2nd Dist. N. Y. 172. Decided December 27, 1911.

engineering, superintendence, promotion fees, legal services and expenses $275,538; making a total of $1,589,850. These notes were transferred as before to the two trustees, so that at the time of this application all the outstanding stock (except $5,000 par value), and all the bonds and outstanding notes were owned by certain persons acting through the two trustees. These securities totalled approximately $2,057,000.

The applicant now asked permission to replace the existing $1,000,000 mortgage with one for $3,000,000, and to issue bonds to the amount of $1,500,000 thereunder. Of these proposed bonds, $350,000 were to be used to refund the outstanding bonds of the same amount and $1,150,000 to be issued to said trustees at a discount of 15 per cent in part payment of the notes held by them. Additional capital stock was to be issued to the amount of $771,764, of which $612,350 was to be issued to said trustees in further payment of the notes held by them; $9,415 to reimburse income for road and equipment expenditures, and $150,000 for working capital; thus practically all the proposed bonds and stock were to be exchanged for the notes held by the trustees.

As noted above, the Commission held that the construction period ended when operation began, and that thereafter it was not proper to charge interest upon cost to capital account but to pay it from earnings.

Under the circumstances in this case, February 1, 1908, was adopted as the end of the construction period for the original part of the road. The investigation showed that upon this date this part of the road represented an investment of not over $355,000 as against a capitalization of $117,000 par value of stock, and bonds to the amount of $350,000 —a total of $467,000. If the stock represented par value, as required by law, the bonds would represent property value of $235,000. If the bonds had been issued at 80 this would bring the $235,000 up to $280,000, and if the period from February 1, 1908 to July 31, 1911 were to be regarded as a period upon which interest could be charged to capital, as contended by the company, this would bring the amount up to $350,000. This would have been the payment of three years of operation out of capital.

The construction of the original part of the road did not seem to have been subject to flagrant abuse in the matter of capitalization, but the other parts of the system had been built under a different arrangement, with a different construction company, the New York and Nassau Construction Company, a New Jersey corporation. Both the traction company, and the construction company, however, were controlled by the same individuals. The contract between the traction company and

the construction company provided merely that the "construction, installation and operation described, contemplated or done under this agreement" should be satisfactory to the president of the traction company, while the latter agreed to pay the construction company "the actual cash cost," including law expenditures, taxes, and any damages for which the construction company might be liable. In addition the construction company was to be paid the following percentages:

(a) 10 per cent upon labor and services and 15 per cent upon materials and property. This in practice had, when added to the "actual cash cost", formed a new basis upon which were computed:
(b) 10 per cent for engineering and superintendence;
(c) 7½ per cent for "services in obtaining franchises and other rights, interesting investors in the enterprise, temporary financing and other necessary promotion and financing in connection with this agreement,"
(d) 5 per cent for "the necessary legal services and expenses required in carrying out the purposes of this agreement."[13]

These percentages would have totalled from 33½ to 39 per cent, but in view of the fact that only a small part of the work was done directly by the construction company, they amounted to nearly 50 per cent on the major portions of the work.[14] Upon the basis of these charges the outstanding notes were made up according to the company's statement, as follows:[15]

[13] See 3 P.S.C.R. 1st Dist. N. Y. 63.

[14] See 3 P.S.C.R. 1st Dist. N. Y. page 76.

[15] In the estimates submitted by the Coney Island and Brooklyn Railroad (2 P.S.C.R. 1st Dist. N. Y. 336. Opinion adopted July 29, 1910) the Commission approved ten per cent for contractor's 'overhead,' and charges, and profit upon the entire cost of labor and materials. This also included an allowance to cover the overhead charges of the general contractor. Ten per cent was also allowed for engineering and incidentals, and was divided into two parts: First, engineering, and second, incidentals, including superintendence, inspection and contingencies. By the latter was meant expenses that might arise in the course of construction which were not anticipated when the estimate was made, together with loss or wastage of material. There was an item of $12,051 of expenses incurred in connection with procuring the right to relocation and construction. These expenses included condemnation proceedings, consents of public authorities and property owners, litigations, negotiations, canvassers expenses, printing engineers' services, condemnation commissioners, real estate experts and attorney's disbursements. In addition, there were attorney's fees to the amount of $50,000, making $62,200 in all. The Commission regarded two to five per cent as the usual percentage for legal work in connection with construction, but in consideration of the legal difficulties involved in the present case, it was decided to allow bonds to be issued for this amount upon condition that one-half be allowed to be permanently capitalized, and the other half paid off in twenty years by the creation of a sinking fund, although bonds would be permitted for such half.

Actual net cost	$1,072,239.53
A—Contractor's profit	152,372.89
B—Engineering and superintendence	122,461.24
C—Securing franchises and promotion	91,845.93
D—Legal expenses	61,230.62
Interest during construction	89,699.28
Total	$1,589,849.49

A thorough investigation by the Commission placed the actual cost at $1,169,042, not counting interest. The applicant, meanwhile, modified its claim to $1,500,150, which left it still in the position of asking approval of securities in excess of actual payments to the extent of $330,000.

This seemed to be a typical case of the interior construction company, a dummy corporation formed for the purpose of enabling a favored few to divert a portion of the security proceeds to their own pockets. This form of abuse is responsible for much of the existing inflation in railroad securities. The Commission expressed itself as follows:

> Ordinarily when recourse is had to construction companies it is because they have better facilities for purchasing supplies, can obtain lower prices, and have a more expert and competent engineering staff—because the traction company believes the construction company can provide a better and cheaper plant than it could build if it were to do the work directly. But there is no such justification in this case. The construction company here did not exist previously; it had no staff of engineers or organization; it had no favorable connection with supply houses; it had no experience; it had nothing which the traction company itself did not have. The traction company could have done all of the work with equal facility and with the same results.[16]

As the Commission pointed out, the two parties to the construction-company contract were nominally distinct corporations, but were actually controlled by the same persons, and thus the contract was not an expression of the free play of open competition of the relation between a willing buyer and a willing seller, but a "document signed by persons acting one moment in one capacity and the next in another." The contractor company might have been given 50 per cent instead of 10, for in reality what the individuals paid out as the traction company they got back as the construction company.[17]

In the Manhattan and Queens case, where similar conditions prevailed, the First District Commissions held in regard to a contract be-

[16] See 3 P.S.C.R. 1st Dist. N. Y. page 76.

[17] See middle page 79, 3 P.S.C.R. 1st Dist. N. Y.

tween the corporation and the construction company that, "the two companies were so closely related that the construction contract was not an agreement between separate and distinct companies having no common interest, but a document signed by two parties representing a single interest."[18]

It was further held that such a contract had no probative force.

The opinion in this case pointed out that if a construction company was entirely distinct from the operating company, if the persons controlling the one had no connections with the individuals controlling the other, then, in that case, an operating company would not make a contract with a construction company unless it had reason to believe that it could save money by so doing, as compared with doing the work directly. In such a case, the Commission pointed out, the operating company would invite bids from competing construction companies. Under such conditions there would be no room for such percentages for overhead charges as existed in the present contract. Further, it was held, where persons heavily interested in the operating company had no interest in construction companies, their own self-interest would cause them to invest as little as necessary to the end that the return on invest-

[18] The following instance of a recent ruling (April, 1917) by a board of referees in connection with a case involving a typical interior construction company may be of interest in connection with the above discussion: In a suit brought by the City of New York against the Empire City Subway Company, Ltd., the capitalization of the company was subjected to a thorough investigation, in the course of which it appeared that a large part of the construction work had been done by a construction company which, in the words of the referees appointed to pass upon the case, "was in fact the construction force of the Empire transferred to a new corporation created by the creators of the Empire." This construction company had received 15 per cent profit upon cost of construction. The referees, in ruling upon this 15 per cent question, held that in letting out contracts to its own construction company the Empire Company had brought an additional person into the work of providing subways and that compensation for this third person was necessarily added to the cost. "In view of the fact," ruled the referees, "that this additional person was not at the time an independent contractor of experience and with a trained force and did not even own an independent plant, equipment, etc., but received them by transfer from the Empire City Company and was in fact the construction force of the Empire transferred to a new corporation created by the creators of the Empire, we are not prepared to allow the 15 per cent on its cost paid to the Union (such new corporation so created) unless it were shown affirmatively and clearly that the whole cost charged—actual by contractor plus its percentage—did not exceed what it would have cost had the original method been pursued, the Empire using its plant, equipment, etc., and receiving its pay for engaging in the enterprise, not from any percentage of actual cost, but in some other way."

ment might be as large as possible. But where a majority in interest of the stockholders of an operating company, consisting generally of a clique of "insiders," also controlled a construction company, which often was organized for the occasion, in such a case it was to the interest of this clique to make a contract with the construction company by which the latter would get exorbitant profits. The minority stockholders suffered for the enrichment of the small clique, and the consuming public would be made to suffer to the extent to which rates could be fixed by the management.

"The Commission," the opinion in the North Shore case stated, "does not favor the formation of a construction company by the persons who control the corporation with which such construction company is to do business."[19]

The circumstances in this class of cases all go to show that contracts with interior construction companies are used as a means of inflating security issues. They help to cause a multiplicity of inter-company relations which obscure the real conditions. In the case under discussion an individual who was an officer in both the traction company and the construction company frankly admitted one reason for such an arrangement in the following language: "In the first place, the people who were in this concern, and who had put their money into it, wanted to have a contract that would give them as much of the securities as they could get out of it."[20]

In the original hearing upon the application of the Longacre Light and Power Company for permission to issue securities the fact was brought out that the applicant had already entered into a contract with a corporation known as the American and British Manufacturing Company. It followed that if the Commission granted the application the proceeds of the proposed securities would be expended in accordance with the terms of this contract. The contract provided, among other things, that the applicant should pay the net cost of all apparatus, materials and work provided by the A. & B. Company, as shown by vouchers approved by the engineer of the applicant; that the latter should pay all the expenses of the A. & B. Company for engineering, superintendence and employees used upon the work; should pay, in addition, 15 per cent as a

[19] Matter of application of the Manhattan and Queens Traction Corporation, 5 P.S.C.R. 1st Dist. N. Y. 57. Order entered February 5, 1914. See page 66.

[20] See middle page 80, 3 P.S.C.R. 1st. Dist. N. Y.

clear profit to the A. & B. Co; and should make such payments in notes providing for the public or private sale of bonds held as collateral.

The A. & B. Company could (according to this contract) sell $400,000 of bonds now in the treasury of the applicant at 70; could sell subsequent issues for "a fair market value"; was to receive 5 per cent commission of the first two items of securities; could sublet this contract in whole or in part, and the amount paid to the sub-contractor under this sub-contract should be taken as cost upon which the 15 per cent profit to the A. & B. Company was to be computed. Here we have the interior "construction company" in all its glory, and with numerous facilities for injecting "water" into the proposed capitalization. In the words of the Commission, "the construction contract does not adequately protect the interests of the Longacre Company or of the public."[21]

The company later agreed to so alter this construction contract as to remove the most objectionable features. It was further agreed that the construction company should make no profit through the marketing of securities, and that its profit for doing work should be reduced to 5 per cent.

Actual Cost and not Reproduction Cost New as the Proper Basis for Securities

The North Shore Company, after failing to impress the First District Commission with the validity of their original "construction company" claims, as discussed previously, sought to have the question approached upon the basis of "reproduction-new-less-depreciation," referring to cases in which this basis had been used. The Commission pointed out that in such cases that basis was used as one factor, but not as the only factor, and that it was used as one factor only as an emergency in cases where the actual cost of the existing property was not known.

In the present case, the applicant's "actual cost" already included $38,000 for engineering and superintendence, $40,000 for obtaining franchises, and upon the basis suggested the Commission was asked to proceed to add percentages to cover these very items now included. The Commission held that "actual cost as shown by actual vouchers should be the basis of action in this case, subject naturally to any evidence that may throw doubt upon the propriety of any item or that may indicate the omis-

[21] Matter of application of the Longacre Electric Light and Power Company. 1 P.S.C.R. 1st Dist. N. Y. 226. Opinion adopted June 26, 1908.

sion of any item. Vouchers are not conclusive against all other evidence, but they are not to be cast aside without reason."[22]

Similarly, in another case, the First District Commission held that

> in no case has the Commission undertaken to substitute an estimate for actual cost, and it has been repeatedly stated that resort has been had to estimates only when there were no records. In no instance, when a new company was being formed such as in the present case, has the Commission allowed securities to be issued and charges made to capital account on the basis of an estimate of what might be the cost. The Commission has held that securities should be issued upon the basis of actual cost, unless there was evidence of inflation or the payments appeared to be unreasonable or unnecessary.[23]

Again in the same opinion, the Commission held that "all payments and charges to capital should not be made on the basis of what might be paid a contractor under other circumstances and under other conditions, but on the basis of actual and necessary net cost."[24]

As a result of its investigation the Commission reached a total of $1,600,000 total construction cost, as compared with the $2,272,000 originally applied for, a reduction of $672,000 or practically 30 per cent.

New York Commissions Not Obliged to Consider Applications for Securities as a Whole

In the opinion handed down by the Appellate Division of the Supreme Court upon the decision of the First District Commission denying the application of[25] the Longacre Electric Light and Power Company for leave to issue securities, the Court held as follows:

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[22] The Appellate Division of the Supreme Court of New York in its decision upon the opinion of the First District Commission, which opinion denied the application of the Longacre Company, held that the Commission, in objecting to the applicant's contract with the construction company, showed a tendency to do precisely what the Court of Appeals had said that they were not authorized to do, viz.: "to substitute their judgment for that of the board of directors or stockholders of the corporation as to the wisdom of a transaction." See People ex rel. Longacre Electric Light and Power Company v. Public Service Commission. 137 App. Div. 810. Decided April 22, 1910. See also People ex rel. Delaware and Hudson Company v. Stevens, 197 N. Y. 1. Decided December 7, 1909.

[23] See 3 P.S.C.R. 1st Dist. N. Y. page 83.

[24] See matter of application of the Manhattan and Queens Traction Corporation. 5 P.S.C.R. 1st Dist. N. Y. pages 71 and 75. Order entered February 5, 1914.

The following is a list of important cases in which it was held that securities should be issued upon the basis of actual cost:

[25] People ex rel. Longacre Electric Light and Power Company v. Public Service Commission. 137 App. Div. 810. Decided April 22, 1910.

the Commission when application is made to it to approve of an issue of securities, is not obliged to consent or refuse consent to the whole application as presented, but may authorize the issue of such securities as it deems to be reasonably required for the enumerated purposes of the corporation, and refuse its consent to the remainder of the issue desired to be made.

Matter of application of Rochester Corning Elmira Traction Company, 1 P.S.C.R. 2nd Dist. N.Y. 166. Decided March 30, 1908.

Matter of application of the Interborough Rapid Transit Company, 1 P.S.C.R. 1st Dist. N. Y. 149. Opinion adopted April 23, 1908.

Matter of application of the Manhattan Railway Company, 1 P.S.C.R. 1st Dist. N. Y. 205. Order adopted June 12, 1908.

Matter of application of the King's County Lighting Company, 1 P.S.C.R. 1st Dist. N. Y. 700. Opinion adopted July 2, 1909.

Matter of application of the Nassau Electric Railroad Company 2 P.S.C.R. 1st Dist. N. Y. 124. Opinion adopted September 30, 1909.

Matter of application of the Coney Island and Brooklyn Railroad Company, 2 P.S.C.R. 1st Dist. N. Y. 130, 336. Opinion adopted October 22, 1909. Opinion adopted July 29, 1910.

Matter of application of Bronx Gas and Electric Company, 2 P.S.C.R. 1st Dist. N. Y. 150, 476. Opinion adopted November 12, 1909. Opinion adopted December 30, 1910.

Matter of application of King's County Electric Light and Power Company, 2 P.S.C.R. 1st Dist. N. Y. 193. Opinion adopted January 24, 1910.

Matter of application of the New York Edison Company. 2 P.S.C.R. 1st Dist. N. Y. 276. Opinion adopted March 22, 1910.

Matter of application of Coney Island and Brooklyn Railroad Company,2 P.S.C.R. 1st Dist. N. Y. 481, 783, Opinion adopted December 30, 1910. Opinion adopted December 30, 1911.

Matter of application of the Longacre Electric Light and Power Company. 2 P.S.C.R. 1st Dist. N. Y. 593. Opinion adopted July 28, 1911.

Matter of application of the Third Avenue Bridge Company. 2 P.S.C.R. 1st Dist. N. Y. 779. Opinion adopted December 30, 1911.

Matter of application of the Third Avenue Bridge Company. 3 P.S.C.R. 1st Dist. N. Y. 209. Opinion adopted March 8, 1912.

Matter of application of the New York Railways Company. 3 P.S.C.R. 1st Dist. N. Y. 397. Opinion adopted November 1, 1912.

Matter of application of the King's County Electric Light and Power Company. 3 P.S.C.R. 1st Dist. N. Y. 473. Opinion adopted December 17, 1912.

Matter of application of New York Dock Railway. 4 P.S.C.R. 1st Dist. N. Y. 94. Opinion adopted March 28, 1913.

Matter of application of Bronx Gas and Electric Company, 4 P.S.C.R. 1st Dist. N. Y. 199. Opinion adopted. April 29, 1913.

Matter of application of the Belt Line Railway Corporation, 4 P.S.C.R. 1st Dist. N. Y. 411. Opinion adopted November 7, 1913.

Matter of application of the New York Connecting Railway Company, 4 P.S.C.R. 1st Dist. N. Y. 456. Opinion adopted November 14, 1913.

The Longacre Electric Light and Power Company applied in April, 1908, for authority to issue $10,000,000 of preferred stock and also to issue bonds to be secured by a mortgage upon its property. The application was denied, principally on the ground that no certificate to begin construction had been obtained from the Public Service Commission, or from the preceding Commission of Gas and Electricity.[26] The applicant had been incorporated prior to the taking effect of the Gas and Electricity Commission Act in 1905, but had issued no securities prior thereto. It had done so subsequently without obtaining permission from said Commission. The act in question forbade any increase in capitalization without such permission. The doubt arose as to whether an initial issue was an "increase," but in the minds of the Commission, the doubt was sufficient to affect the legality of such issues, as it was proposed to substitute a part of the proposed new issues for those outstanding. This would clearly not be within the terms of the Public Service Commissions Law, which was based upon the principle that capitalization issued under its provisions should represent full value.

Of the outstanding securities, $500,000 had been issued to private parties in payment for the franchise. If a like amount of new securities were substituted for these, the effect would be the capitalization of a franchise, and this is expressly forbidden by the Public Service Commissions Law.[27]

The new issue of $10,000,000 perferred stock was to be non-voting. The existing stock amounted to 500 shares of $100 each, and under such an arrangement a bare majority of the outstanding stock, 251 shares ($25,100) would place in the hands of its owners complete control of a capitalization aggregating $60,000,000. Of the existing stock, 490 shares were in the hands of one corporation, the Manhattan Transit Company, which had not paid any money for them. Such control, or, at least, the possibility of it, the Commission held, would be inimical to both the investing and the consuming public.

[26] Matter of application of the Longacre Electric Light and Power Company 1st Dist. N. Y. 226. Opinion adopted June 26, 1908.

[27] In the matter of the application of the East River Terminal Railroad Company (1 P.S.C.R. 1st Dist. N. Y. 306. Opinion adopted October 13, 1908) the corporation applied simultaneously for a Certificate of Public Convenience and Necessity and for authority to issue capital stock to the amount of $10,000. It was held by the First District Commission that an application for approval of the issue of stock or bonds must await the procuring of a Certificate of Convenience and Necessity.

The Supreme Court, in the decision[28] referred to in the preceding pages, after discussing the legality of the outstanding bonds, applied the reasoning quoted above to the objections stated by the Commission in its opinion denying the application. The Court held that as the bonds in question formed but a fraction of the proposed issue, the Commission could refuse to authorize an issue to take up the bonds whose legality was questioned. The same considerations were also applied by the Court to the objection in regard to the capitalization of a franchise, as this, it was held, would affect only the question of the amount of the issue, and not the question whether there should be any issue at all. The same answer was made to the objection that the amount of bonds was too large in comparison with the voting stock.[29]

[28] Upon this point the Public Service Commissions Law, (Chapter 480, Laws of 1910) section 69, holds as follows: "The Commission shall have no power to authorize the capitalization of any franchise to be a corporation or to authorize the capitalization of any franchise or the right to own, operate or enjoy any franchise whatsoever in excess of the amount (exclusive of any tax or annual charge) actually paid to the State or to any political subdivision thereof as the consideration for the grant of such franchise or right." In this connection the reader is also referred to the application of the Kings County Electric Light and Power Company, (Matter of application of the Kings County Electric Light and Power Company. 2 P.S.C.R. 1st Dist. N.Y. 193. Opinion adopted January 24, 1910). An investigation of the applicant's balance-sheet showed $405,000 to be invested in stock, bonds and coupons of the Amsterdam Company, of which no portion had been written off. These securities, it was pointed out, represented practically no property except a franchise, and had earned no income for twelve years. The applicant was not operating under this franchise and its only present value arose from the fact that ownership of it prevented others from using it, thereby cutting off competition from such a source. It was held that this was an intangible which ought not to have been capitalized or at least, should not continue to be capitalized. The Commission held that "if such capitalization were justifiable, the capitalization of the refusal of the State or the city or this Commission to allow a competing company to come in would be equally justifiable," and that "in our opinion, this amount of $405,000 should be written off at once, or at least $110,000, the remainder being amortized or accumulated in a sinking fund so that this amount of capitalization will be wiped out when the bonds become due."

[29] People ex rel. Longacre Electric Light and Power Company v. Public Service Commission. 137 App. Div. 810. Decided April 22, 1910.

CHAPTER IV

RATIO OF STOCK TO BONDS

Assuming that a Commission has arrived at an approximate determination of the amount of capital which it should permit for a proposed enterprise, the problem then arises as to how the securities representing this capitalization should be divided between stock and bonds.

Of course, when an approximate determination of the amount of capitalization to be permitted has been arrived at, the fixing of the proportion of bonds, or of stock, automatically fixes the amount of the other. As to which class of security, stock or bonds, should be given primary consideration, it would seem that under any program of public regulation of the security issues of public utility corporations the fundamental requisite would be a reasonable certainty that interest upon bond issues could be regularly and promptly met. If this could not be done, the enterprise would mean losses to investors, and little usefulness to consumers. In the Rochester Corning case, referred to above, the Second District Commission held that a bond issue should have behind it a sufficient margin of money invested by stockholders to prove that "in the judgment of competent business men it (the project) is likely to prove commercially successful."

It might be pointed out here that the restriction of highly speculative enterprises with doubtful chances of success through insistence by Commissions upon a reasonable proportion of stock to bonds is supplementary to a Commission's power in the regulation of rates.

Stockholders in ordinary corporations not under public regulation are, of course, not entitled to the protection that should be afforded to bondholders, since, in theory, there is no limit to their rate of return in cases of large financial success. There seem, however, to be two reasons why they should receive more protection in the case of public utility companies under regulation.

In the first place, the theory of public regulation is to allow such a corporation to charge rates that will net them a fair return and no more. The Supreme Court in the Consolidated Gas case held that six per cent was fair, and eight per cent has been held fair in other cases decided by state commissions. However, if the public, through its regulating body, is to set a limit to the return to stockholders of a financially successful enterprise, it should see that the safety of the investment is increased accordingly.

In the second place, while the amount of money put up by stockholders is theoretically a guaranty by competent men of their faith in the financial success of the enterprise, it may represent, in practice, simply the faith of shrewd men in their ability to dispose of the stock to investors. In such cases, even though such a Commission may disclaim responsibility for the future of the stock, its mere act in granting approval will of itself serve as an added inducement to the purchase of stock and may be used as an effective argument for its sale.

The minimum requirements of any proposal which would attract the attention of experienced men would seem to be assurance of an ability to pay operating expenses, taxes, and adequate provision for depreciation, and still leave a surplus adequate at least for the payment of fixed charges, if not for dividends.

Proceding upon this basis, the Second District Commission followed what might be called "laboratory methods" in seeking to arrive at the probable gross revenues, the probable operating expenses, taxes and depreciation charges, and the probable remainder applicable to fixed charges, in the case of the proposed Rochester Corning road.[1]

Taking advantage of its command of statistical data concerning the operation of trolley roads within the state, the Commission tabulated the chief facts with regard to some thirty-nine similar roads in actual operation under the jurisdiction of the Commission. This information it applied to the proposed project. As a result, it was estimated that the gross earnings of the proposed road would not be greater than $6,000 per mile, or for the 120 miles proposed, $720,000 per year. It was likewise estimated that upon such a road, operating expenses and taxes would not be less than 65 per cent of gross earnings, with 5 per cent additional for depreciation, making 70 per cent in all, thus leaving 30 per cent for payment of fixed charges. Thirty per cent of $720,000 would be $216,000 which, at 5 per cent would warrant a bond issue of not more than $4,320,000.

The Commission, through its engineers, made a careful examination of all the items in the estimate of proposed construction submitted by the applicant and arrived at what it believed to be a generous allowance for construction cost. This estimate totalled the sum of $6,328,715. To this there were added the following items; for unforseen contingencies, 5 per cent, $316,435; for legal expenses, organization tax, tax upon stock

[1] Matter of application of the Rochester Corning Elmira Traction Company. 1 P.S.C.R. 1st Dist. N. Y. 166. Decided March 30, 1908.

to be issued, expense of proceeding before the Commission, expense of marketing securities, engineering and other details, 5 per cent, $316,435; for working capital, $100,000; for promoter's services, 5 per cent, $316,435. This made a total of $7,378,020. These percentages, the Commission stated, were based upon the circumstances of the individual case, and were not to be considered as precedents for subsequent cases.

The total capitalization asked for, including the $120,000 of stock already issued, amounted to $11,276,013. The estimated actual cost, as given above, was $7,378,020, leaving $3,897,993 of capitalization which did not seem to be justified. Taking the estimated cost ($7,378,020) as the amount of capitalization reasonably required, and subtracting from it the $4,000,000 of capital stock applied for, there was left $3,378,020 to be met by the issue of bonds, and that amount was authorized.

The Commission felt that the bonds should not be sold for less than 85, and so ordered. This price for a 5 per cent bond would yield 5.9 per cent. An additional allowance was made for 5 per cent interest for one year to be paid from the proceeds of the securities. In explanation of this it might be stated that bond interest during the construction period is very generally allowed as a capital charge with the restriction that the bonds are not to be sold until the proceeds are actually needed. The construction period is supposed to end when actual operation begins. The selling price of 85, plus interest for one year brought the proposed bond-issue to a total of approximately $4,210,000. The interest charges upon this would be $212,000, as against the $216,000 assumed above to be applicable to fixed charges.

The Commission based its assumptions upon gross earnings of $6,000 per mile. If earnings were not in excess of this amount stockholders would receive no returns. The success in forwarding the enterprise would depend upon the possibilities of the road as an inducement to investment in the capital stock, but bonds should not be permitted to be issued, the Commission held, beyond an amount upon which interest could be assured. In other words, the bondholders take a limited return, and are supposed to be compensated by an assurance of practical safety of principal and the regular payment of such return, while the stockholder is in the position of the man who puts up collateral security with his broker for the protection of the latter, and as tangible proof of his faith in, or, at least, of his willingness to speculate upon the outcome. In the present case, the proposed amounts of bonds and stock were about equal. The Commission, in addition to limiting the amount

of bonds as above outlined, made the requirement that the $4,000,000 of stock must be subscribed before any bonds were issued. This arrangement would afford a reasonable margin of safety for prospective bondholders and at least a moral guarantee that in the judgment of stockholders the enterprise would be financially successful.

In the New York and Ontario Power Company case, referred to upon page 20, the Second District Commission authorized $1,850,000 of bonds and $640,000 of stock, or a ratio of three to one as compared with half and half in the Rochester Corning case. No reasons were given and we infer that the Commission acted upon consideration of the individual circumstances in the two cases.

In the North Shore case,[2] the First District Commission held that if there was not a positive prospect that the undertaking would earn a sufficient amount to meet interest upon bonds promptly after meeting all other charges then such bonds should not be issued; if the future of an enterprise was so uncertain that little return above operating expenses could be assured, it should be financed by stock and the risk put upon stockholders. The Commission took the position that:

> the existence of a corporation ought not to be constantly jeopardized by the fear of foreclosure due to failure to earn in any quarter or half-year the interest on bonds. Under such circumstances the manager will be tempted to neglect maintenance, to omit provision for depreciation and ultimate replacement of worn-out equipment and plant, and to skimp the service rendered to the public.

It is well to emphasize as often as possible the absurdity of allowing such a large bond issue as to tempt or force the management to neglect depreciation reserves in order to meet current interest on the bonds and keep the property out of receiver's hands. Bond interest paid at the sacrifice of depreciation reserves is a cheating proposition for the security holders. Such a procedure first eats into the equity of the stockholders, and, eventually, into that of the bondholders themselves. The effect, in a case where the investment of stockholders was insignificant, would soon result in paying interest to the bondholders out of their own principal. The average investor does not fully realize the results of neglected depreciation.

After thorough investigation the Commission decided to permit $1,600,000 of securities instead of the $2,272,000 originally applied for. The sum of $1,600,000 was based upon the Commission's estimate of the actual value of the property.

[2] 3 P.S.C.R. 1st Dist. N. Y. 63. For quotation which follows see bottom page 74.

Bonds to the amount of $1,500,000 had been asked for to be sold at a 15 per cent discount, netting $1,275,000. To issue $1,500,000 of bonds upon property worth $1,600,000 would seem improper on general principles, but in this case the net earnings had not in any year been enough to meet the interest charges which such an issue would entail, namely, $75,000. Further, during these years no allowances had been made for depreciation, or amortization of discounts. The estimate for the current year, showing some $80,000, was based upon a hoped-for 50 per cent increase in revenue, and allowed insufficient amounts for depreciation and amortization. In view of these circumstances such a large bond issue would place the company in a precarious condition and under constant threat of foreclosure. In this connection the Commission held that:

> The principle that should be applied, held, is clearly that the charges for interest and amortization of discounts upon the bonds authorized should not exceed the amount that will certainly be earned promptly and regularly, after deducting all charges, including reserves for depreciation, etc. It is quite customaryf ro bond houses of standing to go further and require a considerable margin of safety.[3]

It seemed that, if proper depreciation and amortization were to be allowed, the sum applicable to bond interest would not exceed $50,000 and would probably fall below. Upon this basis it was felt that an issue of bonds in excess of $800,000 would not be warranted. Of these, $350,000 were to be used to retire a like amount of outstanding bonds, leaving $450,000 to be issued to represent in part the lines recently completed. Assuming that these bonds had been issued on a basis of 85, they would represent a property value of $297,500. The part of the property upon which the remainder of the bonds were to be issued had greater earning capacity and these bonds should sell at 90, thus representing value to the extent of $405,000, or a total represented by bonds of $702,500. This subtracted from the $1,600,000 left $897,500 to be represented by an additional issue of stock to be sold at par.

The same factor was involved in the application of the Longacre Electric Light and Power Company,[4] known as the Longacre Case. The Longacre Light and Power Company applied to the First Distirct Commission for permission to issue securities preparatory to entering the electric field in New York City in competition with the two existing electric companies, The New York Edison Company, and the United Electric Light, Heat and Power Company. The application was denied

[3] See 3 P.S.C.R. 1st Dist. N. Y. bottom page 86.

[4] Matter of application of the Longacre Light and Power Company. 1 P.S.C.R. 1st Dist. N. Y. 226. Opinion adopted June 26, 1908.

by the Commission several times and was the subject of two court decisions as a result of which the Commission finally decided to permit the company to issue some securities.

In so doing the Commission took the position that the securities should be issued only to the extent necessary to construct the initial plant; that, if securities were issued whose proceeds were not to be used for some time, the applicant would be paying 5 per cent interest and receiving only 2 or 3 per cent.

The minimum amount of expenditure, as estimated by the Commission, called for about $4,600,000 for physical property, and about $900,000 for organization, over-head charges and floating liabilities which did not represent any physical property. From $2,500,000 to $3,000,000 was deemed sufficient for present needs.

It was held that bonds having foreclosure rights should not be authorized to an amount in excess of which interest could be paid with certainty. What then would be the net return? The immensely strong position of the two existing companies made any such estimate uncertain. The amount which was finally taken as probable varied from $200,000 to $300,000, enough to carry at 5 per cent an issue of from $4,000,000 to $6,000,000, preferably the smaller amount.

"Obviously," it was stated, "an approval of this amount by the Commission does not carry with it any assurance that the interest will be earned. Whether the company will be successful depends upon the character of the management."

If the bonds were restricted to the amount of $4,000,000 this would leave $2,000,000 to be raised by stock. The capitalization would then be divided in the ratio of one to two. The Commission held that:

> This ratio is much more liberal than allowed in many states and countries. In several the laws prohibit railroad companies from incurring debt to exceed the amount of capital stock issued. In Great Britain the limit for public utilities is generally less than 50 per cent of the capitalization. France allows about one half for railroad companies. It is evident that from a bondholder's standpoint, the more money contributed by the stockholders, the greater is the security and the less is the risk of the default in interest.[5]

The Order of the Commission authorizing the issue of the securities provided specifically that the given ratio of stock and bonds should be maintained in floating the securities, the portion of stock in each case to

[5] Matter of application of the Longacre Electric Light and Power Company. 2 P.S.C.R. 1st Dist. N. Y. page 603. Opinion adopted July 28, 1911.

be subscribed and fully paid for before the corresponding allotment of bonds was issued.[6]

The Commission stipulated that the bonds should sell at not less than 90 and accrued interest unless first offered to public subscription. All discounts, commissions and expenses connected with the issuance of the securities, not to exceed $400,000, were to be amortized within the life of the bonds. Provision was made for monthly reports to the Commission of the proceeds of sales of stock and bonds and the disposal of the same; also for a properly itemized bill for each expenditure to be submitted to and approved by the Commission.

[6] The paragraph referred to read as follows: "When and only when one million dollars ($1,000,000) of new stock shall have been subscribed and full paid for, two million dollars ($2,000,000) of the bonds hereby authorized may be issued; and when and only when an additional million dollars ($1,000,000) of new stock shall have been subscribed and fully paid for, making in all two million dollars of new stock, two million dollars ($2,000,000) more of the bonds hereby authorized, making in all four million $4,000,000 of such bonds, may be issued."

CHAPTER V

Methods of Control Over the Application of the Proceeds

A very important phase of commission approval of securities consists in the measures adopted by the Commissions to see that their recommendations are carried out. A thorough and continuous supervision by an adequate staff is as indispensible as the power of the Commission to make the original order.

Authorization Conditioned Upon Proper Measures for Amortization and Depreciation

An important factor in the Commission's granting of permission to issue securities in the North Shore case,[1] was the conditioning of the authorization upon proper measures for amortization and provision for depreciation. This has been one of the vital elements of administrative regulation of capitalization. Most people know how the securities of public utility corporations may be inflated when originally issued, but the majority do not realize that it is just as necessary to prevent excess capitalization from creeping in subsequently. This generally happens through failure to provide for the amortization of elements which do not represent tangible or permanent capital investment, such as bond discount, or property revertible to the public after a fixed period; or, through failure to set aside proper reserves for depreciation of the physical property, resulting in a tendency to finance replacements with new capital.

Section Five of the Order in this case imposed such restrictions. It is typical and we quote it herewith as follows:

> Fifth. That in order to provide for the amortization of the following items: $97,500 for discount upon bonds authorized, $342,000 for property which will revert to the City of New York at the end of the franchise, said The New York and North Shore Traction Company shall establish and maintain a cumulative sinking fund, etc.

Originally, in 1902, capital stock to the amount of $33,000 had been issued for organization purposes, securing of franchise, etc. Through delay these rights had lapsed and part of the expenses had to be incurred a second time. In other words, a large part of the $33,000 represented a duplication of intangibles and it was decided that $18,000 of this amount should be amortized. In addition, there were $5,200 of expenses in

[1] Matter of appliction of the New York and North Shore Traction Company. 3 P.S.C.R. 1st Dist. N. Y. 205. Opinion adopted March 8, 1912. See bottom page 207.

connection with the floating of the original bonds, and a loss of $6,500 on a quantity of cable. This aggregated $30,000 and such amount was ordered charged to profit and loss and amortized at the rate of $3,000 per year.

General Restrictions Imposed by the Commissions In the Application of the Proceeds

For the purpose of securing the construction of the Rochester Corning street railway in accordance with the plans and specifications upon which the authorization was made, and not in excess of actual requirements, the Order[2] of the Commission stipulated among other things that no bonds should be issued or sold without the further authorization of the Commission upon the sworn report of the terms of sale, nor until the capital stock was fully subscribed by responsible parties; that bonds should be issued from time to time in instalments of not more than one million dollars each, and only upon the making and entry of an order subsequent and additional hereto authorizing such issue, upon proof on the first application that the capital stock had been subscribed by responsible parties, and upon each application showing for what purpose the proceeds of said bonds were to be used in the construction and completion of the work for which they were authorized and the disposition made of the proceeds of previous issues of stocks and bonds; that no bonds would be authorized upon any such application which were required for the purposes of a general contract or of special contracts for the construction of said road and the furnishing of equipment therefor, if the aggregate amount to be paid under said contract or special contracts exceeded the sum of $7,200,000, nor would such bonds be authorized except upon such applications it was shown that the work was progressing in conformity with the plans and specifications submitted by the company upon the application. The company was further required to report to the Commission all contracts and agreements made in the construction of its road after the same were made so that supervisory powers might be exercised over the proper construction of the road. If the capitalization allowed proved insufficient, a further application could be made, based upon a detailed account of expenditure of the proceeds of the securities already authorized.[2]

The customary form of clause relating to accounts, reports, and audits for the First District Commission reads as follows:

[2] Matter of application of the Rochester Corning and Elmira Traction Company. 1 P.S.C.R. 2nd Dist. N. Y. 166. Decided March 30, 1908.

Fifth: That said company shall keep separate, true and accurate accounts showing the receipt and application in detail of the proceeds of the sale or disposal of the (stock) (bonds) (notes, etc.) hereby authorized to be issued and on or before the tenth day of each month the company shall make verified reports to the Commission stating the sale or sales of said (stock) (bonds) (notes, etc.) during the previous month, the terms and conditions of sale, the moneys realized therefrom, and the use and application of such moneys; and said accounts, vouchers and records shall be open to audit and may be audited from time to time by accountants and examiners designated for such purpose by the Commission.[3]

Elasticity in Orders Governing Expenditure of Proceeds of Securities

One of the dilemmas of the administrative control of capitalization has been the difficulty of providing reasonable elasticity in the expenditure of the proceeds of securities without opening the way to abuse. Very often a company is not able to specify in advance the individual items for which expenditure will be necessary. Besides, changing conditions may call for a revamping of original plans. Therefore, control

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[3] See Rules of Procedure and Regulations, etc. Public Service Commission, First District, N. Y.

The two New York Commissions have different problems to meet. This was especially true in the early years of their existence. As mentioned in the introduction, the First District Commission has jurisdiction over Greater New York, the Second District Commission over the remainder of the state. Roughly speaking, therefore, the former had under it a small number of large corporations, while the latter had charge over a large number of relatively small utilities.

Hence, the procedure of the Second District Commission has not lent itself so well to standardization as that of the First District, and the former Commission has not felt that it was desirable for it to set forth its principles of procedure as formally as the First District Commission has done. In regard to this phase of supervision, we quote from a letter of Mr. H. C. Hasbrouck, Chief of the Division of Statistics and Accounts for the Second District Commission, as follows:

"The extent to which the Commission goes in checking up the expenditures of proceeds from the sale of securities authorized depends upon the nature of the case and the means available at the time for such a check. Most of the capitalization orders issued by the Commission require that the company authorized to sell securities shall report every six months the amount of securities sold under the order, the person to whom the sale was made, the proceeds realized, the amount of the proceeds expended for purposes specified in the order, and a detailed statement of such expenditures by accounts. These reports are checked by the Commission's Division of Capitalization and any discrepancies found are investigated. Sometimes detailed audits are made of the original records of the company as a further check upon the expenditures of proceeds from the sale of securities, and examinations by engineers are occasionally made in connection with such detailed audits. Supplemental petitions and orders are required when the applicant desires to modify the plan originally proposed of expending the proceeds from sales of securities."

conditioned upon the approval by a Commission of a hard and fast program of specified items tends to leave a company unduly restricted in the matter of expenditure, and is open to the same objection as the 'segregated budget' used by some municipalities. Such a method often results in inefficiency, especially with expenditures of considerable amount, and may even prove to be extravagant by forcing a company to make expenditures which subsequent developments would have led it to modify.

On the other hand, a blanket approval by a Commission of the expenditure of a lump sum opens the way to abuse, and may result in the charging to capital account, to a greater or less extent, of items which are not properly capital expenditure. Money obtained from stock or bonds may be used to pay operating expenses or for purposes not considered when the order of approval was issued. Yet it is almost impossible to predict in detail what items of expenditure will actually be required. Conditions may change, and, instead of purchasing new boilers, a new sub-station may be needed by the time the money is actually available.

The fundamental question, assuming the financial plan is worthy of approval, is whether a specific expenditure should be charged to operation and paid out of current income or charged to capital and paid by the issuance of bonds or stock. This question can most properly be decided after the expenditure is actually made and the voucher presented for a Commission's approval.[4]

[4] Mr. W. J. Henderson, Chief of the Division of Capitalization, Second District Commission, states the general attitude of that Commission in this regard as follows:

"This Division, and, I think also the Commission, although I have not heard any specific enunciation of opinion from it on the subject, tends toward favoring the permanent financing which takes place after the prosecution of necessary construction work, and which is accomplished through the medium of the issuance of capital securities to pay off short term debt which has been contracted, and for the purpose of reimbursing the treasury for income moneys temporarily diverted to permanent construction uses. While I have no figures on the subject available, I believe that the larger part of the securities which are authorized to be issued by this Commission are authorized under these circumstances. This being the case, the Commission's Divisions, both accounting and engineering, have an opportunity to examine records and property after, rather than before the actual performances. These examinations are made, as you know, with a view toward not only the mathematical and accounting accuracy of the practices followed incident to the expenditures of money but also along lines which make for a review of the judgment and discretion of those in charge of the enterprises. In making examinations in these cases, emphasis is continually laid upon the constructive side of the work and by advice, suggestion and even by Commission order companys are influenced toward adopting the soundest and most equitable practices in the conduct of the various branches of their business.

Furthermore, if the Commission has a check in this way upon the expenditures actually chargeable to capital, every necessary safeguard against overcapitalization is provided for, and the company may be allowed greater leeway. Then, too, if a company fails to spend a certain small sum for the specific purpose stated in its application and made a part of the order, but does spend it for another capital purpose, and such expenditure is approved, no question can arise as to the legality of the act or as to the violation of an order of the Commission.

The pith of the provision quoted above consists in the elasticity provided. The Commission can approve a general plan of expenditure for improvements and extensions, and the company can offer its securities for sale at once and proceed to apply them, being free to use its own discretion in the matter of details. The company, however, is aware that the day of reckoning has merely been postponed for the purpose of efficiency. It knows that every item of outlay will be subjected to close scrutiny by the Commission (or its agents) before it may be charged to capital account, and that expenditures not so approved must be met from current income.

To achieve these desirable results Commissioner Maltbie outlined a general form of Order for the use of the First District Commission and which is given here, as follows:

CLAUSE 11 WITHDRAWAL OF FUNDS ON APPROVAL

Sixth: That none of the proceeds of the aforementioned (stocks), (bonds), (notes, etc.) hereby authorized for the purposes specified in subdivision . . . of paragraph . . . of section . . . of this order, other than the receipts on account of accured interest, shall be expended by the said company for the purposes specified therein until a properly itemized bill for each proposed expenditure shall have been submitted to the Commission by the company with the certificate of one of its officers that such expen-

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"Even in instances where securities are to be issued for the purpose of defraying the cost of contemplated construction the Commission's Divisions inquire carefully and at length not only into the mathematical accuracy and general propriety of the estimates made to cover the work in question but also into the broader question as to whether the proposed construction work is necessary and proper in the public interest and whether the work is to be economically undertaken. It is proper to add here that the opinions formulated by the Commission as a result of the studies of its various Divisions are not always controlling, in fact I should say that generally the reverse was true. There is no doubt in my mind, however, that this power of review which is placed with the Commission makes for substantial economies in construction and that in many instances constructive criticism which has been given by the Commission has resulted in operating and financial benefits to the Companies affected and thus to the communities which they serve."

diture represents a real increase in its fixed capital as defined in the accounting rules of the Commission and not a replacement of any part of such fixed capital or a substitution for wasted capital or other loss properly chargeable to income, and until such bill shall have been approved by the Commission.[5]

The purpose of such a provision of course, is to overcome the difficulty of estimating accurately the costs of construction in advance without sacrificing the Commission's control over expenditures. In practice the plan has proved to be mutually satisfactory, both to the Commissions and to the corporations.[6]

Another instance of this elastic arrangement for expenditures occurs in an application of the Kings County Electric Light and Power Company for additional capital.[7]

The Commission through its engineers made a careful examination into the requirements of the company so far as concerned this application, and there seemed to be no question but that they would need for extensions, additions and betterments, properly chargeable to capital, the amount of $2,500,000.

[5] See Rules of Procedure and Regulations, etc., Public Service Commission, First District, N. Y.

[6] One of the best instances of the use of this arrangement was in connection with the construction of the New York Connecting Railroad Company. (Matter of application of the New York Connecting Railroad Company, 4 P.S.C.R. 1st Dist. N. Y. 456. Opinion adopted November 14, 1913.) See also matter of application of the New York Railways Company, 3 P.S.C.R. 1st Dist. N. Y. 397. Opinion adopted November 1, 1912. For other examples of elastic arrangement, see also Order of February 5, 1914, authorizing issue of stock in re Manhattan and Queens Traction Company (Matter of application of the Manhattan and Queens Traction Company 5 P.S.C.R. 1st Dist. N. Y. 57.) Also section 3, condition "second," page 59, same reference, for similar clause relating to audit of proposed expenditure of proceeds by the Commission.

Also Matter of Application of the Hudson and Manhattan Railroad Company 6 P.S.C.R. 1st Dist. N. Y. 272. Opinion adopted September 17, 1915.

We quote from the opinion, p. 276, as follows: "The Commission has heretofore requested companies making expenditures for construction or improvement work, for which later applications to the Commission for the allowance of securities may follow, to file monthly or in the case of small expenditures, quarterly, as the expenditures are made, statements showing same. The Hudson and Manhattan Railroad Company has complied carefully and fully with this request with the result that when their application was presented to the Commission it was possible by examination of the periodical statements for the employees of the Commission within a comparatively brief time to testify as to the propriety of allowing the expenditures for capital purposes."

[7] Matter of application of the Kings County Electric Light and Power Company, 2 P.S.C.R. 1st Dist. N. Y. 193. Opinion adopted January 24, 1910.

In view of these facts, the order in this case provided that the company might issue debenture bonds for $2,500,000, the proceeds to be used for extensions, additions and betterments to the physical property. No details were stated, but the Commission reserved the right of passing upon expenditures as made. If any of those submitted were not considered a proper capital charge, they would have to be paid out of current income.[8]

A similar plan was followed by the Second District Commission, pursuant to an application by the Long Island Railroad Company for permission to issue debentures to cover proposed expenditures of some ten million dollars.[9]

The Pennsylvania Railroad Company had been making advances to the Long Island Company for capital purposes. The Long Island Railroad Company also planned during the next few years to make additional improvements to cost over ten million dollars. This capital the Pennsylvania Railroad expected to advance, the plan being to fund these advances from time to time by the issue of debentures.

The chief engineer of the Long Island Company testified that the company knew in a general way what the improvements would cost, but

[8] In the Longacre case, already touched upon, the company submitted a statement of assets and liabilities showing unfunded debt to the amount of $275,000. The original opinion of the Commission had shown that the "book cost" of the fixed capital was much greater than its present value and to what extent these unfunded liabilities represented expenditures chargeable to capital was uncertain. About $75,000, for instance, represented interest on funded debt, which was properly operating expense. At this time the company had a small plant and its earnings were insufficient to pay charges which were properly operating expenses. The Commission in this connection expressed the view that "it may be necessary to exercise the discretionary power vested in the Commission by the statute (Public Service Commissions Law) and permit these debts to be paid from capital funds temporarily. To safeguard the stock and bondholders at this point, a provision should be inserted in the order prohibiting the disbursement of funds until an itemized statement of the vouchers to be paid has been submitted to and approved by the Commission. This plan will allow sufficient time for an examination of the unfunded liabilities and the preparation of a plan for the ultimate extinction of non-capital charges from operating income." A maximum limit of $200,000 was fixed for funds to be used in this way, and as none of the proceeds of stock or bonds could be disbursed without the approval of the Commission, it was felt that the interests of security holders were well safeguarded. In the subsequent order of March 5, 1913, this $200,000 was allowed for the refunding of obligations and $400,000 for expenses involved in the sale of bonds and to make up the discount. Matter of application of the Longacre Electric Light and Power Company, 2 P.S.C.R. 1st Dist. N. Y. 593. Opinion adopted July 28, 1911.

[9] Matter of application of the Long Island Railroad Company, 2 P.S.C.R. 2nd Dist. N. Y. 275. Decided November 18, 1909.

that no detailed estimates could be made with accuracy owing to the fact that unit prices might change during the progress of the work, and that the plans when worked out in detail might increase or diminish the cost considerably. The Commission felt that it could not certify in advance that any particular sum was reasonably required for the execution of the work, as the company claimed that the cost could only be summarized approximately.

To meet this difficulty the president of the Long Island Company suggested as follows:

> There can be statements submitted from time to time showing the actual expenditure, and as I understand it, we would only issue these debentures at the end of the year; we could not issue them from month to month because some months when the Pennsylvania advances to us we pay back within the next month more than they have advanced in that month. It is only in a short month and when our construction vouchers are very heavy that the advances are larger; and we have got to take at the end of the year the balancing up of the accounts and figure out just the exact cost of construction work for the year.[10]

The Second District Commission agreed to the plan outlined, which would permit the applicant to proceed with construction for a year. Accurate accounts were to be kept of the progress of the work, and at the end of the year, upon proper proof, the Commission would authorize the issue of a proper amount of debentures to the Pennsylvania Railroad Company with which the applicant proposed to keep a running account.

[10] See preceeding reference.

CHAPTER VI

The Commissions and the Investor

In a recent decision handed down by the Appellate Division of the Supreme Court of New York for the First Department it was stated that the purpose of the creation of the Public Service Commissions was "to provide protection for the investing and traveling public."[1] The extent of this protection to the investing public is, however, hazy in the minds of most people. There are investment houses that place a deal of emphasis, in a general way, upon the fact that securities have been approved by a Public Service Commission. If in so doing they aim to give prospective investors the impression, even by inference, that securities so approved are practically guaranteed in the matter of return, then to that extent they deceive investors and misrepresent Public Service Commissions. It should also be borne in mind that commission approval of a new issue of stock or bonds does not validate existing issues of a utility corporation.

The Power of the Commissions to Protect the Investor

In the decision of the Appellate Division of the Supreme Court of New York upon the Dry Dock case, the Court refers to "the settled policy of the law as now determined by the Legislature and interpreted by the courts," and states that under this policy "the approval of the Commission to the issue of new securities, whether it be for refunding or for other purposes, is notice to the public that the securities so authorized by it represent at least investments made by the company for capital account and not disbursements for mere temporary purposes."[2]

The sections of the Public Service Commissions Law dealing with approval of security issues permitted the respective classes of utility corporations under the jurisdiction of the Commissions to issue securities for certain specified purposes *with the written approval of the proper commission.* This authorization must state that in the commission's opinion the amount is reasonably required.[3]

[1] People ex rel. New York Railways Company et al. v. Public Service Commission. 181 App. Div. N. Y. 338. Decided February 18, 1918.

[2] People ex rel. Dry Dock, East Broadway and Battery Railroad Company v. Public Service Commission. 167 App. Div. 286. Decided May 7, 1915.

[3] The condition was stated as follows:

"provided and not otherwise that there shall have been secured from the proper commission an order authorizing such issue, and the amount thereof and stating that in the opinion of the commission the use of the capital to be secured by the issue of

Thus, the statute under which the Commissions were created apparently gave them full power to require that securities should not be authorized except where the value of the property was equal to the amount of the proposed securities.[4]

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such stock, bonds, notes or other evidence of indebtedness is reasonably required for the said purposes of the corporation, ..." Laws of 1907. Chapter 429, sections 55 and 69.

As amended in 1910 this clauses was tightened up so that it read:

"provided, and not otherwise, that there shall have been secured from the proper commission an order authorizing such issue, and the amount thereof, and stating the purposes to which the issue or proceeds thereof are to be applied, and that in the opinion of the commission the money, property or labor to be procured or paid for by the issue of such stock, bonds, notes or other evidence of indebtedness is or has been reasonably required for the purposes specified in the order." (Laws of 1910, Chapter 480, same sections as above.)

The law further provides that

"for the purpose of enabling it to determine whether it should issue such an order, the commission shall make such inquiry or investigation, hold such hearings and examine such witnesses, books, papers, documents or contracts as it may deem of importance in enabling it to reach a determination" (see *supra*).

Section 55 of the Stock Corporation Law forbids the issue of stock or bonds except for money or labor or property at their respective values.

[4] In the decision handed down in the Delaware and Hudson case (People ex rel. Delaware and Hudson Company v. Stevens, 197 N. Y. 1. Decided December 7, 19-09), Judge Haight expressed himself as follows:

"For a generation or more the public has been frequently imposed upon by the issues of stock and bonds of public service corporations for improper purposes, without actual consideration therefor, by company officers seeking to enrich themselves at the expense of innocent and confiding investors. One of the legislative purposes in the enactment of this statute was to correct this evil by enabling the commission to prevent the issue of such stock and bonds, if upon an investigation of the facts it is found that they were not for the purposes of the corporation enumerated by the statute and reasonably required therefor."

In the discussion of the powers conferred upon the Commission, the same opinion held further:

"We do not think the legislation alluded to was designed to make the commissioners the financial managers of the corporation, or that it empowered them to substitute their judgment for that of the board of directors or stockholders of the corporation as to the wisdom of a transaction, but that it was designed to make the commissioners the guardians of the public by enabling them to prevent the issue of stock and bonds for other than the statutory purposes; these purposes we have already enumerated in quoting the statute, the last being for the discharge or lawful refunding of its obligations. . . . It was, therefore, evidently the legislative intent in the enactment of this provision that the commissioners should have supervision over the issuing of long-time bonds to the extent of determining whether they were issued under and in

The corollary of this power, of course, is the power of the Commissions to supervise the expenditure of the proceeds through their engineering and accounting staffs, to the end that the purposes upon which the authorization is conditioned may be carried out. Such measures have been referred to upon preceding pages.

But in the decision of the Court of Appeals in the Third Avenue case it was stated that, while as a general rule the Public Service Commissions Law gave the Commissions power to base authorization of securities upon the test that the value of the property should be equal to the value of the securities proposed, yet "there may be exceptions to that rule."[5] One exception was held to be the amount of securities issuable upon a plan of reorganization. The existing reorganization law gave purchasers of a bankrupt corporation power to reorganize upon the basis of the old securities, plus any sum actually paid in cash. In view of the existing specific law dealing with reorganizations, the Court held that the general powers of the Public Service Commissions Law did not give the Commissions power to limit the amount of new capitalization to the value of the property. Hence, it followed that the Commissions did not have power adequately to protect prospective investors in the matter of securities issuable upon a plan of reorganization. This evident defect in the law was remedied by the "reorganization amendment" added to the Public Service Commissions Law in 1912.[6] This amendment gave the Commissions power to base the amount of proposed capitalization in a reorganization case upon the value of the property, and hence, to protect investors adequately.

Refunding securities, as yet, occupy a less desirable position from the investor's point of view. Under the decision of the Appellate Division of the New York Supreme Court in the 'Dry Dock' case, it was held that the Commissions did not have the power to base the amount of such securities upon the value of the property.[7] In this case, in which

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conformity with the provisions of the statute for the purposes mentioned therein, or whether they were issued for the discharge of the actual and not the fictitious debts of the company, or whether they were issued for the refunding of its actual obligations and not for the inflation of its stock or bonds."

[5] People ex rel. Third Avenue Railway Company et al. v. Public Service Commission, 203 N. Y. 299. Decided November 21, 1911.

[6] Chapter 289. Laws of 1912.

[7] People ex rel. Dry Dock, East Broadway and Battery Railroad Company v. Public Service Commission, 167 App. Div. 286. Decided May 7, 1915. The highest judicial tribunal in the State of New York is the Court of Appeals, and not the Supreme Court, which is subordinate to it.

application was made for the approval of the issue of new securities for refunding purposes, the Commission based their denial of the application chiefly upon the ground that the value of the property involved was not equal to the amount of the proposed new securities.[8] The Commission's decision was appealed to the Appellate Division of the New York Supreme Court, which supported the decision of the Commission in refusing approval of the proposed securities. The Court held, however, that the Commission did not have power to apply the test of actual value of the company's property and its earning capacity as a criterion for its approval of the proposed securities but that it—

> was right in refusing to approve their issue until the relator had proven that the securities sought to be refunded represented actual investments for the company's capital account. Therefore, it seems to be quite immaterial how long ago the original securities were issued where the approval of the commission is sought to a refunding issue and proof of such investments must still be given as a basis for the action of the commission.

The Court then set down as the considerations which, in its judgment, the Commissions were empowered to use in a refunding case, the three following tests:

> (1) Whether the proposed issue is reasonably required for the refunding purpose. (2) Whether the expenditure to be refunded is a capital, as distinct from an operating or income charge. (3) If the expenditure to be refunded is an operating or income charge, whether such refunding should nevertheless be permitted under the exception clause of the statute which reads: 'Except as otherwise permitted in the order in the case of bonds.'

Since the Commission's denial of the company's application was supported by the Supreme Court, the Commission is prevented by this legal technicality from appealing the case to the Court of Appeals. This is regrettable, as the present situation indicates a loophole in the Commissions' powers to protect prospective investors, which defect can be remedied only by a subsequent judicial interpretation, or by an amendment of the Public Service Commissions Law similar to the "reorganization amendment," previously referred to.[9]

[8] Matter of application of the Dry Dock, East Broadway and Battery Railroad Company for permission to issue Refunding Bonds, 5 P.S.C.R. 1st Dist. N. Y. 141. Opinions filed March 3, 1914. See also pages 213 and 337 for rehearings on above.

[9] After the Appellate Division of the New York Supreme Court handed down the decision in the 'Dry Dock case' referred to above the company again applied to the Commission (First District). The latter, in view of the holding of the Court, felt compelled to authorize more securities than the value of the property warranted. The opinion in the case was written by Commissioner Hayward, and he expressed the re-

The Court evidently sought to assume a position analagous to that taken in the Third Avenue case.[10] If so, the validity of the position is not clear. For in the case of securities issued for refund there is no pre-existing specific statute to conflict with the general powers of the Public Service Commissions Law, as was the case with reorganizations.

In a decision handed down by the same Court on January 18, 1918, and discussed later on, it was held that the purpose of the Public Service Commissions Law was the protection of the investing and travelling public, and that in pursuance of this purpose, both the settled rules of statutory interpretation regarding implied powers necessary to execute powers explicitly given, and the enabling clause contained in Section Four of the Act gave the Commissions adequate powers.[11] This reasoning could be applied to securities for refunding purposes.

In the decision of the New York Supreme Court, Appellate Division, in the Third Avenue case, the Court observed, as mentioned above, that while as a general rule the Public Service Commissions Law gave the Commissions power to base proposed security issues upon the value of the property, there might be exceptions to the rule. The Court then pointed out that one such exception was to be found in the statute itself; that:—

luctance with which the Commission acted in the following language: (Matter of Aplication of the Dry Dock, East Broadway and Battery Railroad Company to Issue Bonds, 7 P.S.C.R. 1st Dist. N. Y. 59. Opinions adopted May 4 and May 25, 1916. For quotation, see page 83):

"One of the broad underlying purposes of the Public Service Commissions Law was to insure against over-capitalization, and it has always been the proud boast of this Commission that securities would not be authorized beyond the value of the property subject to them, or under such circumstances that it could not reasonably be anticipated that the interest thereon would be paid. The decision of the Appellate Division however held that in the case, at least, of refunding securities, the value of the company's property and its ability to pay interest upon the proposed issues could not be considered by the Commission. Under that decision, therefore, the purpose of the Public Service Commissions Law in this regard might very well be frustrated and refunding bonds insufficiently secured might very well be issued with the approval of this Commission stamped upon them to hasten them into the hands of the unwary investor."

[10] People ex rel. Third Avenue Railway Company v. Public Service Commission, 145 App. Div. 378. Decided June 9, 1911.

[11] Section 4, Chapter 48 of the Consolidated Laws of New York reads as follows: "There shall be a public service commission for each district, and each commission shall possess the powers and duties hereinafter specified, and also all powers necessary or proper to enable it to carry out the purposes of this act."

in the case of the merger or consolidation of two or more corporations it is provided that the capital stock of the corporation formed by the merger should not exceed the capital stock of the corporations consolidated and any additional sum paid in in cash. Thus, in the case of merger, the limit of the amount of stock of a corporation is dependent, not on the value of its property, but on the stock outstanding of the constituent corporation prior to the merger.[12]

This is true. The fact of the matter is that corporations applying for permission to consolidate are generally in a prosperous condition and therefore the question of protecting investors does not assume great importance. In one case of consolidation in the Second District (see page 221) the Commission used the value of the property as one test, but the power of the Commissions to base proposed capitalization in a consolidation case upon the value of the property has never been tested in the courts. In theory it is hard to see why the doctrine of "implied powers" referred to above would not apply.

In view of the broad attitude assumed in this recent decision of the Supreme Court of New York it may be pertinent to give it some mention here, although it has since been reversed. The Court pointed out that if the Commissions did not have power to compel corporations to set aside adequate depreciation funds, then, when in the course of time it became necessary to replace obsolescent and depreciated equipment, no funds would be available, as a result of which reorganization would be necessary, and would be accompanied "with the consequent material impairment of securities." Even if power existed to finance replacements by the issue of additional securities, the fatal ending for the investor would merely be postponed. The Court held as follows:

If the Legislature has left this loophole in its scheme for the protection of the security holders it has made a serious blunder. Such a fate has befallen too many of these corporations and it was largely to prevent just such catastrophies that this Commission was created. The Court should not so construe the powers given as to permit the very evils which the Legislature has sought to remedy. This holding now made (supporting the Commission's power to compel a corporation to reserve sufficient depreciation funds) does not substitute the judgement of the Commission for that of the Board of Directors except so far as may be absolutely necessary *to provide for the maintenance of the value of the securities*[13] and of adequate facilities for transportation by the requirement to pay what is deemed 'operating expenses' from income and as I read the statute in view of the purposes of its enactment this authority is there given.

This decision of the Appellate Division of the New York Supreme Court was appealed by the company to the New York Court of Appeals.

[12] People ex rel. New York Railways Company et al. v. Public Service Commission. 181 App. Div. N. Y. 338. Decided January 18, 1918.

[13] Italics not in original.

The latter reversed the lower court and denied to the Commissions power "to require the creation of a reserve fund to renew the plant when the same shall be worn out or become obsolete."[14] Therefore, as the law now stands in the light of the interpretation of the highest court in the State, if a corporation does not choose to set aside sufficient funds to protect their property adequately against the effects of depreciation, and thus protect the holders of their securities, the Commissions cannot compel them so to do. To such an extent the Commissions now lack the power to protect investors against undermining of their investments.

The Commissions, with their extensive powers, still possess means of making hard the way of the transgressor as regards the neglect of depreciation, in spite of the denial of specific powers by the Court of Appeals. The principle laid down by the United States Supreme Court in the Knoxville Water case still holds,[15] and the corporation which wilfully neglects provision for depreciation can expect little sympathy, either from commission or court, in time of trouble. In other words, it is quite possible for the Commissions to build up an 'unwritten law' with regard to the ethics of setting aside reserves for depreciation.

Unquestioned powers upon the part of the Commissions to compel adequate provision for depreciation would, however, prove to be a great factor in the promotion of sound financial management of public utilities.

To recapitulate, then, the powers of the Commissions to protect investors to the extent of basing approval of security issues upon the value of the property is now unquestioned in the case of original securities, and those based upon a reorganization. In cases of refunding securities, this power has been denied by the New York Supreme Court, Appellate Division, but has yet to be tested before the Court of Appeals. The powers of the Commissions in this regard in connection with cases of consolidation and merger have not as yet been subjected to judicial interpretation. The Commissions do not have the power to require the creation of a reserve fund to renew the plant when it shall be worn out or shall become obsolete.

The Duty of the Commissions to Protect the Investor

In the case of the application of the Hudson River Electric Power Company for leave to issue bonds, the Second District Commission, in

[14] People ex rel. New York Railways Company et al. v. Public Service Commission, 223 N.Y., 373. Decided May 14, 1918.

[15] City of Knoxville v. Knoxville Water Company, 212 U. S. 1. Decided January 4, 1909. For quotation pertinent to the above discussion see page 107.

passing upon the issuance of the additional capital, included as one consideration, the following: "Whether there is any reasonable prospect of fair return upon the investment proposed, to the end that securities having apparent worth but actually little or no value may not be issued with our sanction."[16]

In commenting upon this question more in detail the Commission stated its position as follows:

> We think that to a reasonable extent the interest of the investing public should be considered by us in passing upon these applications. The Commission should satisfy itself that in a general way the venture will be likely to prove commercially feasible, but it should not undertake to reach and announce a definite conclusion that the new construction or improvement actually constitutes a safe or attractive basis for investment. Commercial enterprises depend for their success upon so many conditions which cannot be foreseen or reckoned with in advance that the duty of the Commission is discharged as to applications of this character when it has satisfied itself that the contemplated purpose is a fair business proposition.[17]

In its consideration of the application of the Rochester Corning Railway Company for leave to issue securities, the Second District Commission, in discussing the possibility of return upon the proposed stock expressed the opinion that it did not devolve upon the Commission "to collect data for or suggest reasons for those who are willing to invest their money in the capital stock of this enterprise. They must judge upon their own information and according to their own experience."[18]

Attention was called, however, to section 55 of the Stock Corporation Law, which forbids the issue of stock or bonds except for money, labor or property at their respective values.

The position taken as to the Commission's responsibility to prospective bondholders was expressed as follows:

> We conceive that we should not permit an issue of bonds beyond an amount upon which, in our judgment, the enterprise will be able to pay interest. While this Commission cannot in any respect be responsible any more morally than it is legally for returns upon bond issues which it authorizes, it would certainly be derelict in its duty to the public if it permitted a bond issue upon which it was not fairly reasonable to expect that the interest would be paid from the legitimate earnings of the enterprise. It must be clearly understood that in arriving at conclusions upon so important and delicate a point, the Commission cannot arrive at results satisfactory to itself and to the public except upon a conservative basis, and it would be in the highest degree reprehensible for the Commission to permit any corporation to offer bonds upon the market which

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[16] Matter of application of the Hudson River Electric Power Company for Permission to Issue Bonds, 1 P.S.C.R. 2nd Dist. N. Y. 51. For quotation see page 67.

[17] See preceding reference, page 67.

[18] 1 P.S.C.R. 2nd Dist. N. Y., p. 188.

the Commission, in the exercise of its best judgment and with full command of all the statistical data regarding the operation of roads within this State, did not feel to have a reasonable satisfactory assurance from all the circumstances of the case that the interest would not be defaulted.[19]

The First District Commission, in the Third Avenue cases, and in numerous other instances, have p aced great emphasis upon the principle that they should not authorize the issue of bonds upon which the charges could not be met w:th reasonable assurance. In the case of stock the investor is concerned almost exclusively. In the case of bonds, however, doubt as to the ability to meet the fixed charges involves the interest of the consuming public as well as of the investing public, for such failure precipitates corporate death and subsequent reorganization. This always spells impairment of service as well as impairment of securities.

It must be clearly understood that a Commission is not an investor's agency. The most that any Commission can do legally, or should do, is to certify, after proper investigation, that, to the best of its knowledge, such securities represent actual capital invested, and that the project offers a reasonable prospect of a fair return upon the proposed investment. To go further than this would amount practically to the underwriting by the State of the uncertainties of business risk and efficiency, or otherwise, of management in each case.

Commission regulation to-day stands between private management and government ownership. If it fails government ownership is inevitable, and there are those who think that the Commission movement received its inspiration, in large measure, from far-seeing public service corporations who sought to head off government ownership, for a while at least.

It should be borne in mind, however, that to ask the State to assume risk properly belonging in the domain of private management would involve sharing with it the profits of a successful enterprise. Private management cannot have both the penny and the cake, and the minute we ask the State to assume business risks, we have entered the field of government ownership. Cases could be cited in which a Commission had, after thorough investigation, authorized securities upon what it considered a very conservative basis, and yet the corporation was afterwards unable to meet the interest upon its first mortgage bonds. Nevertheless, the money represented by the securities had been honestly invested. Such instances do not reflect upon Commission regulation of securities. For instance, an electric railway may be built in a suburban district which

[19] See preceding reference.

seems to offer every prospect of rapid growth. But the reason why people fancy one suburb and not another is often past understanding, and a district which seems especially promising may stand still for years, or even go backward. Commissions have no clairvoyant powers and such risks they were never intended to assume.

The Addition of New to Old Securities

One of the results of a period of transition between an old and a new regime of control is the situation brought about by the addition of Commission-approved securities to existing securities whose validity has not been passed upon. The effect is to reduce all to an average value as concerns a possible distribution of assets.

An interesting instance in point was involved in the application of the Watertown Light and Power Company for the issue of additional securities.[20] The purpose of the issuance was the discharge of certain lawful obligations incurred in the making of improvements, the desirability of which was not disputed.

The Company already had a capitalization of $700,000, which had been allowed by the former Commission of Gas and Electricity. The City of Watertown claimed that under the present outstanding securities of $700,000 the company was greatly over-capitalized and that before any application for additional securities should be granted a careful valuation of the property of the corporation should be made. In other words, that, notwithstanding the fact that the propriety of the additional capitalization, judged upon its own merits, was not questioned, its issuance should nevertheless be conditioned upon the soundness of the existing capitalization.

The purpose of the issue was to discharge certain indebtedness, but indirectly, to capitalize certain improvements, and the situation was in reality the same as if the applicant had come to the Commission for permission to issue securities for the financing of future improvements.

The position taken by the Second District Commission was that to hold up needed improvements while the exact condition of the corporation and the value of its present capitalization was being determined, would be to defeat one of the main purposes of the existence of the Commission, that is, the furnishing by a public utility of that adequate service to which the public is entitled. It was possible, the Commission felt, that it might become involved in endless complications, and that improve-

[20] Matter of the application of the Watertown Light and Power Company, 1 P.S.C.R. 2nd Dist. N. Y. 146. Decided March 10, 1908.

ments badly needed for the efficiency of the public services might be held up while facts were ascertained, which, however valuable they might be in themselves, would not help the Commission in deciding the point at issue, namely, the propriety of the additional capitalization asked for in the light of the purposes for which it was to be used, and the necessity therefor.[21]

It was decided that in this proceeding no further inquiry would be made into the subject of the value of the properties of the Watertown Light and Power Cmpany, and that the case would be considered as closed, and determination (as to the additional issue applied for) would be made upon the record heretofore made (the capitalization of $700,000 allowed by the former Commission of Gas and Electricity and which was in dispute).

In the closing paragraph of its conclusion the Commission drew attention to the fact that the stock hereby authorized to be issued "will necessarily find its value fixed by consideration of the value of that heretofore issued; with which, being common stock, it stands on a parity in any distribution of the assets of the company. As to the value of such former issued stock the Commission expresses no opinion, having no knowledge, that point not having been a subject of inquiry."[22]

This case is a good example of that class of cases in which an additional issue of stock whose soundness is approved by a regulative body is added to an existing capitalization whose soundness is more or less doubtful. To take the present case as a concrete example: this corporation had an existing capitalization of $700,000; suppose fifty per cent is over-capitalization; the Public Service Commission, after a careful investigation, allows $200,000 additional stock, represented by one hundred

[21] "The past of a corporation, whether financially faulty or blameless, should not of itself bar the way to its rendering of efficient service in the present or future," the Commission held. It decided unanimously "that the Public Service Commission will not investigate or inquire into the correctness of the capitalization of the Watertown Light and Power Company authorized by the former Commission of Gas and Electricity; and, therefore, will not inquire in this proceeding into any alleged over-capitalization of the applicant existing at the time the application was made. That the investigation upon this application for additional capitalization will be confined to the question whether such capitalization should be authorized by reason of the actual investment of money for the purpose of the corporation recognized by law as a subject of capitalization." See preceding reference (page 155).

[22] See page 165. 1 P.S.C.R. 2nd Dist. N.Y.

per cent of value; as soon as the additional $200,000 of one hundred per cent stock is thrown into the pot with the existing $700,000 of stock of fifty per cent value, both issues are placed upon a parity. The value of each share of the combined $900,000 becomes approximately sixty-one per cent; the $200,000 of new one hundred per cent stock loses thirty-nine per cent and the $700,000 of existing fifty per cent stock ganis eleven per cent.

The investor in the new stock who thinks that because a Public Service Commission has taken care to see that it represents full value, that therefore it will be worth one hundred per cent would find himself sadly in error in any subsequent distribution of assets. He might also fare in a similar way in a subsequent rate case, if the corporation became involved in such to an extent that a valuation of its property was necessary.

In this connection the Second District Commission stated its position to the following effect:

> That in any proceeding before the Commission based upon alleged unreasonableness of rates charged by the Watertown Light and Power Company the Commission will take into consideration the entire capitalization of that company and whether it is overcapitalized, and if so, to what extent, in reaching a final determination upon the lawfulness of such rates, and the Commission will not hold itself bound by the determination of the former Commission of Gas and Electricity, as to the amount of the capitalization authorized by that Commission.[23]

The same principle would hold true in the case of bonds if improper financial management—wastefulness or misappropriation of funds, capitalization of replacements, neglect of depreciation reserves, or what not—had gone so far as to wipe out the equity of the stockholders and infringe to a greater or less extent upon the values underlying the bonds. Such instances are rare in comparison, but have nevertheless happened, the only difference being that the bondholders have the equity of the stockholders as additional security.

As said before, this condition results from a period of transition, and furthermore, the Commission is not an investors agency. The investor is aware that when the new capitalization is added to the old, all is put upon a parity, and he must conclude for himself as to the actual value thereof.

[23] See 1 P.S.C.R. 2nd Dist. N. Y. 156.

CHAPTER VII

The Commissions and the Courts

The general public have a feeling, whether well-founded or not, that the decisions of the Commissions are influenced by fear of appeal to the courts. That is, that they fear judicial reversal of their decisions in those cases in which the courts might take issue, and 'trim their sails' accordingly. There is no doubt that where a marked change of public policy is introduced, as in the case of the enactment of the Public Service Commissions Law in New York State in 1907 and the institution of the powerful administrative bodies brought into being thereby, the courts do keep a zealous watch to see that such bodies assume only such powers, in kind and extent, as the Legislature intended should be given them, and, with their traditional conservatism, the courts may interpret the law with undue strictness. But to conclude from this that the commissions are afraid to speak their own minds, or that the courts are upon the watch for a chance to reverse the commissions, is unwarranted.

All sovereign power, under our system of government, resides in the people of a state, acting through its Legislature, except for those powers which have been delegated to the federal government through the Constitution of the United States and the amendments thereto. These residual powers of the state legislature are limited only by the provisions of the state constitution as interpreted by the state courts. Hence the powers of the state judiciary with regard to enactments of the legislature itself, are limited to the function of passing upon the constitutionality or unconstitutionality of the act. For instance, in 1905 the Legislature of the State of New York passed a law limiting the retail price of gas in New York City to 80 cents. This act was contested in the state courts upon the ground that it results would be confiscatory, which, if true, would render it unconstitutional. This case was later carried to the Federal courts and to the United States Supreme Court upon the same grounds (under the 14th amendment).

The Public Service Commissions are administrative agents of the Legislature, and, so to speak, represent the Legislature in continuous action. Their powers, however, are not co-extensive with those of the Legislature, but are specific powers delegated to them by an act of the Legislature and circumscribed by the terms of that act. As compared with their functions toward the acts of the Legislature, the function of the state courts towards the ruling of the Public Service Commissions is

to pass upon such rulings in the light of their interpretation of the amount of its power which the Legislature meant to bestow upon the Commissions, assuming, of course, that the courts regard the act bestowing the powers as constitutional. It may frequently happen that the Legislature in framing its grant of power does not express itself with sufficient clearness to convince the court. The Legislature may have intended to give the Commissions powers to remedy certain abuses, and the Commissions, in their desire to correct such evils, may feel that such powers have been given, but if the language of the Legislature is not sufficiently specific to convince the courts that such powers were intended to be granted, then the courts cannot justly be accused of prejudice toward the Commissions. It may, perhaps, be taken for granted, in all fairness, that there is a certain amount of bias upon the part of the Commissions in interpreting their powers liberally in order to correct abuses of whose resultant evils they see continual evidence, and also a certain amount of bias upon the part of the courts in limiting legislative grants of powers, unless the intent of the Legislature is expressed in unmistakable terms.

Proper Attitude of the Commissions Toward the Courts

This leads up to the point that there is a definite attitude which the Commissions should assume toward the courts, irrespective of the attitude which the courts may seem to assume toward them. There is no reason why a Commission should assume the attitude of being 'browbeaten' by the courts, or should feel that a reversal of its opinion by the courts is necessarily a rebuke. The duty of a Commission is to do its duty as it sees it, and if the courts decide that it is not empowered to perform its duty in that regard, then the sooner that fact is advertised to the Legislature and to the people of the State, the sooner can relief be afforded by grant of the necessary power. A commission which will abandon principle and deliberately 'sin against light' through fear of a court reversal can never be of vital service to a community. If a Commission takes its position upon the rock of sound finance it can rest assured of ultimate justification, for a public service commission represents the State Legislature itself, and if it is prevented from performing its fundamental duties to the public, either through unwarranted restriction in the judicial interpretation of its powers, or through an actual defect in the powers granted by a Legislature, it is doing a great public service by focusing attention upon the inadequacy of its powers. The fact is that a court reversal may be the quickest means of remedying a defect in the

law, and proved to be so in the Third Avenue case,[1] in which the reversal of the First District Commission's ruling resulted in the so-called 're-organization amendment' to the Public Service Commissions Law.

In the opinion rendered by the Second District Commission in connection with the second application of the Binghamton Light, Heat and Power Company for authority to issue bonds which, in the opinion of the Commission, involved capitalization of replacements, Chairman Stevens made the statement that "if the Commission . . . does not possess the power to curb and regulate financial methods of corporations subject to its jurisdiction which are a manifest fraud upon the investing public . . . then it is time that fact is known to us and the world."[2]

As an expression of the attitude which a Public Service Commission should assume toward the courts upon a vital principle, this statement cannot be improved upon.

It may be claimed that the point has been overdone and that commissions do not act against their better judgment through fear of court reversals. It is to be hoped that such instances are comparatively rare, but there was a Second District case in which the Commission, upon their own admission, approved a totally unjustifiable issue of bonds through fear of the courts. The case is touched upon briefly, not with the idea of reflecting unduly upon the Second District Commission, especially in view of their courageous attitude in numerous other cases, but as an instance of where a Commission proceeded upon what we claim to be a wrong conception of what should be their attitude toward the courts. It would seem that the case should have been considered in connection with the duty of the Commissions toward investors, just previously discussed. We did not include it there because we regard it as an isolated case.

A small trolley road, the Hudson River and Eastern Traction Company, planned extensions much larger than its original trackage and applied for approval of a relatively very large bond issue for that purpose.[3]

[1] See page 197.

[2] Matter of application of the Binghamton Light, Heat and Power Company for rehearing. 2 P.S.C.R. 2nd Dist. N. Y. 566. Decided August 25, 1910. (See top page 567.)

[3] Matter of application of the Hudson River and Eastern Traction Company for authority to issue stock and bonds, 3 P.S.C.R. 2nd Dist. N. Y. 172. Decided December 27, 1911.

Without going into details, we may say that the applicant corporation desired to issue bonds to the amount of $850,000, to be sold at 80, for the following purposes:

Cost of completing construction and equipment of road	$621,000
Cost of a proposed branch	25,000
For deficit due to inability to pay operating expenses, taxes and fixed charges[4]	34,000
This made a total of	$680,000

the proceeds of $850,000 of bonds sold at 80.

The first two items pertained to new construction, and involved bonds to the amount of $806,000. They were considered primarily in connection with the outstanding capitalization of the company, and secondarily in connection with the plan to finance them upon the proceeds of bonds alone.

The existing capitalization stood as follows:

Stock	$84,000
Bonds	75,000
	$159,000

Of the stock, $9,000 had been paid in cash, but an investigation of the books and records of the company convinced the Commission that the remaining $75,000 of stock was merely a stock bonus, and that the present capital was represented by $9,000 cash paid for stock and the original $75,000 of bonds. Upon such a basis there were to be issued, according to the proposed plan, $806,000 of new bonds.

The Second District Commission, in considering the propriety of permitting the issue of this amount of bonds, referred to the position which it had assumed in the Rochester Corning case, and which we have discussed previously in relation to the proper ratio between stock and bonds. This position, stated briefly, was that for the protection of bondholders enough stock should be issued to cover a reasonable share of the cost of construction. The Rochester Corning application was

[4] The part of the application which involved the issue of bonds to meet the deficit was immediately denied. In the application of the Long Island Railroad Company to issue debenture bonds for expenses incurred the Commision held that indebtedness arising from temporary operating deficit is an operating expense and is not properly capitalizable. Matter of Application of the Long Island Railroad Company 2 P.S.C.R. 2nd Dist. N. Y. 275. Decided November 18, 1909.

largely a pioneer case, and about four years had elapsed between it and the present case. Referring to the position taken then, the Commission expressed itself as follows:

> To the opinion thus expressed this Commission still adheres without the slightest abatement in any respect, except that decisions of the courts made since the opinion was promulgated have placed in more than doubt the power of the Commission to determine whether capitalization should be by stock or bonds alone or a division of the same between the two, against an express determination of the corporation itself. If the Commission clearly and unequivocally possesses the power which it then supposed it had, it would exercise the same in this and every other case in accordance with the principles above enunciated.

The Commission did not mention any specific court decisions to substantiate its statement that the courts had cast "more than doubt" upon the power of the New York State Commissions to fix the ratio of stock to bonds as against that presented in the application of the corporation itself. If this statement of the Second District Commission referred to the decision rendered by the court in the Delaware and Hudson case, as it undoubtedly did,[5] it would seem to be in error, as that decision related to a case in which the Second District Commission had refused approval to an issue of bonds for the purpose of refunding short term notes, the proceeds of which had been used to acquire property outside the business of the Delaware and Hudson as a railroad company, and which the Commission regarded as an unfortunate investment. The Court of Appeals held that this was a matter wholly within the discretion of the Board of Directors of the road.

Suppose, for instance, that a railroad company, instead of buying electric power, saw fit to erect a power station for the manufacture of its own current, and should finance the same by issuing notes to run for twelve months or less. This, of course, it could do without the consent of the Commission. Eventually the corporation would, in most cases, come to the Commission for permission to refund these notes into long term securities. In such case it would not lie with the Commission to hold that in its judgment the company should have bought its power instead of erecting a plant of its own. In so doing it would, in the light of the Delaware and Hudson decision, be usurping the authority properly belonging to the directors. It could, however, decide that the company should refund the notes with stock instead of bonds, if there was any

[5] People ex rel. Del. & Hud. Co. vs. Stevens, 197 N. Y. 1. Decided December 7, 1909.

doubt as to the ability to meet the interest upon the bonds, and in this respect the Delaware and Hudson decision would not be in point.

The applicant company in this case insisted that stock, if issued, could not be sold, and that, therefore, the construction of the extension was dependent upon the issuance of the full amount of bonds applied for. It would seem that if the only way to finance the project was by a bond issue of $806,000, to be supported by an outstanding stock issue of $84,000, of which $75,000 was supposed to be bonus, it should not be undertaken at all.

The applicant corporation submitted figures of estimated returns upon which it sought to justify the proposed bond issue. The estimates were based upon annual gross earnings of $10,425 per mile, while a study of twelve similar railways reporting to the Commission showed, for 1910, gross returns per mile varying from $4,081 to $7,564.

If the proposed new construction were built entirely with bond proceeds, as proposed, there would, of course, be no equity in the property to protect the bondholders' lien except the $9,000 cash paid in upon the original stock. The bondholders could get no return until operating expenses, taxes and depreciation were paid. If depreciation were neglected for a time as a makeshift to enable interest to be paid on the bonds, this would simply be undermining the principal of the bonds, and a continuance of such a practice for any length of time would cause the bondholders to find themselves with a worn out property upon their hands, and with no funds for its renewal.

The Commission pointed out that investors as bondholders could get no more than 5 per cent return, with a prospect of default in that return if earnings were insufficient, while as stockholders they would be entitled to all returns above operating expenses, taxes and depreciation, and with no more risk than they would have as bondholders. In other words, where bonds constitute such an overwhelming portion of the capitalization, their security is no greater than that possessed by stock, while they are still subject to limitation of return.

"It is possible," said the Commission, "for every evil which ordinarily follows from a disproportion of bonds and stock to be found in this case." Because it felt that it was forced to authorize the amount of bonds applied for, the Commission seemingly tried to place the onus upon the directors of the corporation. The opinion held as follows:

It (the Commission) must distinctly disavow in this case any responsibility to the purchasers of the bonds as to the earning power of this road, or as to the probability, or possibility even, of the road's paying its fixed charges. The directors must as-

sume the sole responsibility of putting out upon the world these securities and of inducing people who have not studied the subject to invest their money. People who do invest their money in these bonds must make their own calculations as to their worth and as to the probability of their being worth the sum paid for them. The Commission cannot ndertake in this case to act as guardian for them, and the authorization of these bonds by the Commission must not be understood by anyone that the Commission considers them a safe and prudent investment.

Such a position seems incompatible with any theory of effective regulation. The Commission, it is true, is not supposed to guarantee investments, either stock or bonds, even when issued upon a reasonable basis, but in this case the bondholders had none of the protection which their limitation of return implies, and which is supposed to differentiate bonds from stock. The bondholders, under such approval, assumed not only the ordinary business risk incident even to bonds, but all the risk, and, besides, the success of the project was regarded as very unpromising. The very fact that the chance of success for the undertaking was so uncertain seems to have been the chief reason submitted by the company for the issue of bonds. It was stated that stock could not be sold. If the project was not feasible from a financial point of view, the mere fact that it was financed by bonds instead of stock could make no difference. Evidently, the applicants sought to take advantage of the reputation for security which bonds have as compared with stock, as a factor in disposing of the proposed securities. We fail to see any other interpretation to a plea that bonds should be permitted because stock could not be sold. The Commission disclaimed responsibility for inducing "people who have not studied the subject" to invest their money in such bonds. Such people constitute the bulk of the investing public, and probably always will, and if regulatory bodies cannot see to it that bonds issued with their approval are reasonably safe, one wonders what the function of a Commission is. Under such lax regulation, its approval would act as a snare.

While the Commission felt that it lacked specific powers to protect investors by refusing to authorize this issue of bonds, it endeavored to accomplish the same end in a roundabout way. In the order authorizing the issue there was inserted a clause describing the unsatisfactory nature of the bonds. It was compulsory upon the applicant corporation to have this clause printed upon the bonds. No bonds were ever sold.

Such methods may be better than nothing, but it is questionable whether sound progress can be made along these lines, even where specific powers are inadequate. Of course, a commission may let it be known

that it strongly favors certain general policies, and that corporations which act in accordance therewith will be looked upon more favorably than those which do not. But if a commission seeks to overcome the lack of specific powers by the use of technicalities, we soon have what, in essence, is petty persecution. In other words, the principle is bad, however meritorious the aim may be, and the principle that the end justifies the means is the only excuse for such a course. It still seems that the soundest course would be to focus public attention upon the defects in the law, even if it is necessary for a commission to run the risk of a court reversal in so doing.

The Attitude of the Courts Toward the Commission

The attitude of the courts during the early years of the Commissions was, on the whole, hostile. The courts proceeded upon the theory of 'strict construction,' and this, probably, was to be expected. The Delaware and Hudson decision was heralded as a successful effort upon the part of the courts to 'clip the wings' of the Commissions, and was much overrated as to its actual limitation of the powers of the Commissions because corporation attorneys appearing before the Commissions used it with great frequency, whether it had any direct bearing upon their case or not. The real point upon which it was based, as stated previously, involved an investment by a railroad company outside its public service business and was not typical of the general run of capitalization cases. The corporations thought that it greatly limited the powers of the Commissions, largely because the wish was father to the thought.

The Third Avenue decisions, both of the Supreme Court and of the Court of Appeals, were based upon the technical ground that an existing specific law is not repealed by implication by a subsequent general law. The reasoning was no doubt sound, but aside from this, the general tenor of the decisions was extremely hostile.

Where securities are in question which have been issued prior to the regime of the Public Service Commissions the courts have shown an unmistakable opposition to radical action by the Commissions, even though the actual value underlying the securities may be largely fictitious. This was true in the Third Avenue decisions and also in the decision of the New York Supreme Court, Appellate Division, in the Dry Dock case, where the court denied the power of the Commissions to apply the test of the value of the property, although no existing specific law was involved, as was the case with reorganizations.

Where capitalization of replacements has been concerned, however, the courts have shown much more of a tendency to support the Commission. This was especially true in the Binghamton case, where the Court of Appeals actually reversed the Second District Commission upon the point at issue (the reduction by $100,000 of the capital stock of the Binghamton Company as a condition of the approval of a bond issue),[6] but in which decision the 'obiter dicta' concerning the unsoundness of capitalization of replacements was so extensive and so unmistakable in its tenor as to have the effect of a supporting decision upon that question. The last few years, however, have shown a distinct trend, upon the part of the courts, toward the theory of 'implied powers' in construing the powers of the Commissions, and a distinct trend, also, in the recognition by the courts of the nature of the Public Service Commissions as technical, expert, administrative bodies whose function it is to pass upon questions of fact, and whose judgments in this field should not be subject to review except in so far as they may exceed the powers delegated to them by the Legislature. The courts have shown much less of a tendency to substitute their own judgments upon these matters of fact for those of the Commissions, and more of a tendency to confine themselves to the pure questions of law involved in those cases appealed to them.

This was notably so in the so-called Douglaston case. This case is discussed at some length on page 243. The people of Douglaston, a village of Long Island, were supplied with electricity, but not with gas. The supply of both gas and electricity in this district, and the franchise for supplying the same were controlled by subsidiaries of the Consolidated Gas Company of New York. The gas company refused to supply gas, upon the ground that the investment required would not be self-supporting for some time. The people of Douglaston appealed to the Public Service Commission for the First District. The latter ordered that mains be laid. It appeared that the fixed charges upon the necessary expenditure would be about $3,000 per annum, while the additional income would be about half that amount.

[6] In Justice to the Second District Commission, attention should be called to the fact that it did not assume power to force a corporation to write off a portion of its capital stock as a condition for the authorization of this bond issue. The proposition was made voluntarily by the applicant corporation, and accepted by the Commission, and the Commission's order in the case was drawn in accordance therewith. The corporation then appealed to the courts, thus leaving the Commission in the position and having assumed such power, and this view was evidently adopted by the courts.

The company appealed the Commission's order to the Appellate Division of the Supreme Court for the First District, which reversed the Commission. The Court ruled that:

> the promise here (of adequate return upon the investment) is so remote that it does not seem to us reasonable to require this company to make this expenditure for this construction in view of the fact that the only requirement for gas is for cooking and heating in the summer months, and that the place is already supplied with electricity for illumination."[7]

It is interesting to note here the tendency, referred to elsewhere, for monopolies in control of both gas and electricity to shift consumers to one or the other where facilities for both are not already installed, but it is surprising that a court should uphold such a doctrine.

The Commission appealed the case to the Court of Appeals of New York and were supported.[8] The Court of Appeals in its decision pointed out that the Public Service Commissions are authorized by law "to order reasonable improvements and extensions of the works, wires, poles, lines, conduits, ducts and other reasonable devices, apparatus and property of gas corporations, electrical corporations and municipalities."[9]

The Court of Appeals in its decision, quoted from the decision of the Supreme Court, Appellate Division, (N.Y.) as follows: "We have no doubt that under this law the question remains for the court to determine upon the review of the determination of the Public Service Commission whether the extension ordered was a reasonable extension." In discussing this view of the Supreme Court, the Court of Appeals expressed itself to the following effect:

> This statement of the law is quite likely to create a misapprehension as to the power of the court. The court has no power to substitute its own judgment of what is reasonable in place of the determination of the Public Service Commission, and it can only annul the order of the Commission for the violation of some rule of law.[10]

Continuing, the court held that the Public Service Commissions—

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[7] People ex rel. New York and Queens Gas Company v. Public Service Commission, 171 App. Div. 580. Decided March 3, 1916.

[8] People ex rel. New York and Queens Gas Company v. Public Service Commission, 219 N. Y. 84. Decided October 3, 1916.

[9] See Consolidated Laws. New York, Chapter 48, section 66.

[10] See also, Minnesota Supreme Court in States v. Great Northern Railway Co. (153 N. W. Rep. 247), as follows: "The order may be vacated as unreasonable if it is contrary to some provision of the Federal or State Constitution or laws, or if it is beyond the power granted to the Commission, or if it is based upon some mistake of law, or if there is no evidence to support it, or if, having regard to the interests of both the public and the carrier, it is so arbitrary as to the beyond the exercise of a reasonable discretion and judgment."

were created by the Legislature to perform very important functions in the community, namely, to regulate the great public service corporations of the State in the conduct of their business and compel those corporations adequately to discharge their duties to the public and not to exact therefor excessive charges. It was assumed perhaps by the Legislature that the members of the Public Service Commissions would acquire special knowledge of the matters intrusted to them by experience and study, and thus when the plan of their creation was fully developed they would prove efficient instrumentalities for dealing with the complex problems presented by the activities of these great corporations. It was not intended that the courts should interfere with the commissions or review their determinations further than is necessary to keep them within the law and protect the constitutional rights of the corporations over which they were given control.[11]

In conclusion, the Court of Appeals held that the Appellate Division of the Supreme Court did not have the power to determine that the extensions of the company's gas mains, as ordered by the Public Service Commission was unreasonable in the sense that it was an unwise or inexpedient order, but only that it was unreasonable if it was an unlawful, arbitrary, or capricious exercise of power.

The Court observed that if such a decision (the decision of the Appellate Division of the Supreme Court) were allowed to stand, it would seriously hamper the Commissions in the discharge of their duties and would go far toward defeating the efforts of the Legislature to establish agencies to regulate the public service corporations.

This decision of the New York Court of Appeals thus clearly defines the functions and limitations, both of the Commissions, and of the courts, in passing upon their rulings.

In the case of People ex rel. New York Railways Company et al. vs. The Public Service Commission, the Appellate Division of the New York Court for the First District showed marked tendency to treat the Commissions upon the basis of 'implied powers.'[12] This case is discussed in full at page 129, but for present purposes it may be said that at the time of the organization of the New York Railways Company as a reorganization of the old Metropolitan Company, the First District Commission,

[11] See also Interstate Commerce Commission v. Illinois Central Railroad Co. (215 U. S. 452, 470. Decided January 10, 1910) where the Chief Judge, after defining the power of the court said: "It is equally plain that such perennial powers lend no support whatever to the proposition that we may, under the guise of exerting judicial power, usurp merely administrative functions by setting aside a lawful administrative order upon our conception as to whether the administrative power has been wisely exercised. Power to make the order, and not the mere expediency or wisdom of having made it, is the question."

[12] 18 (App. Div. N. Y.) 338. Decided January 18, 1918.

as a condition of its approval of the new securities, issued an order under date of February 12, 1912, requiring the company to set aside monthly 20 per cent of its gross operating revenue for maintenance and depreciation. The company protested that this was a matter for the board of directors to decide, but nevertheless continued to obey the order as it (the company) had covenanted under its mortgages to comply with all orders of public authorities. It appealed the order of the Commission, and on January 18, 1918, the Appellate Division handed down a decision supporting the order. The Court pointed out that inasmuch as the record of the company showed that of the 20 per cent set aside, 16⅔ had been necessary for maintenance, thus leaving 3⅓ per cent for a fund against the time when depreciation and obsolescence would necessitate large expenditures for renewals, that therefore, the order was not unreasonable. The company did not contest upon this ground, but solely upon the ground that the setting aside of such a fund belonged within the jurisdiction of the board of directors.

Upon this point the Court held that the purpose of the creation of the Public Service Commissions was the protection of the travelling and investing public: that a time would come when it would be necessary to replace the property to a large extent in order for the company to continue to function for the public service; that the Commissions possessed no powers to approve securities to finance such renewals (capitualization of replacements) and that therefore reorganization would be inevitable. This would mean serious impairment, both of service and of securities. If the Commissions did not possess the powers adequately to guard against such inevitable consequences, they did not possess power to execute the purposes of their creation. These powers, the Court claimed, they did possess upon two grounds, first, the settled rules of statutory interpretation by which power is impliedly given to take such action as may be necessary to make effective the powers explicitly given to accomplish the purpose of the enactment; second, by Section Four of the Public Service Commissions Law, which provided that "There shall be a Public Service Commission for each district and each Commission shall posess the powers and duties hereinafter specified *and also all powers necessary or proper to enable it to carry out the purposes of this act.*"[13] It was further stated that "*The Court should not so construe the powers given as to permit the very evils which the Legislature has sought to remedy,*"[14] and in conclusion, that: "This holding now made does not substitute the

[13] Italics in the court opinion but not in the act.

[14] Italics not in the court opinion.

judgment of the Commission for that of the Board of directors except so far as may be absolutely necessary to provide for the maintenance of the value of the securities and of adequate facilities for transportation by the requirement to pay what is deemed in law 'operating expenses' [15] from income, *and, as I read the statute in view of the purposes of its enactment,*[16] this authority is there given."

This is certainly the recognition of the theory of 'implied powers' as applied to the Public Service Commissions and would seem to open a vista of increased usefulness in the achievement of sounder methods of utility financing.

The Court added that: "While the powers given to the Commission have been *in some cases strictly construed,*[17] no case has denied to the Commission powers absolutely necessary to accomplish the purposes of its creation."

The reference to strict construction may or may not be a tacit admission, but in the light of the rather hostile attitude adopted in some of the earlier cases it seems significant.[18]

[15] The courts agree in regarding proper allowance for depreciation as 'operating expenses.'

[16] The majority opinion was written by Justice Smith.

[17] Italics not in original.

[18] To the foregoing majority opinion there was a dissenting opinion by Justice Scott. This brief minority opinion illustrates so well the 'strict construction' policy, especially when taken in conjunction with the 'broad' construction policy of the majority opinion in this case, that the liberty has been taken of quoting it in full, as follows:

"I am unable to concur in the decision about to be made simply because I cannot find in the Statute any authority for the order brought up for review. I do not for the purposes of this appeal question the proposition that prudent management of a corporation like the relator requires that some part of its earnings should be set aside for the establishment of a fund to meet possible future depreciation of plant, nor do I question the power of the Legislature to authorize the Public Service Commission to determine what proportion of the earnings should be so devoted.

"The difficulty I find is that the Legislature has not conferred such power. The respondent relies on Section 52 of the Public Service Commissions Law, but that Section as I read it relates only to the manner of keeping the accounts, and has no reference to the manner in which the income share shall be expended. My brother Smith finds authority in the Commission to make the order appealed against, in the broad language of Section 4 of the Public Service Commission Act which confers upon the Commission "all powers necessary or proper to enable it to carry out the purposes of this Act." If the compulsory establishment of a depreciation fund was one of the declared purposes of the Act, this clause would undoubtedly authorize the order sought to be reviewed. But the difficulty I find is that it is not one of these declared purposes.

The minority opinion of Justice Scott, of the Appellate Division of the Supreme Court, quoted in the preceding footnote, is of double interest in that it is the identical position taken in the unanimous opinion which the New York Court of Appeals handed down some four months later.[19] They, too, interpreted the Public Service Commissions Law upon the basis of 'strict construction,' and ruled that section 52 of the statute, referred to above, empowered the commissions, not to regulate the management of a corporation's finances, but simply to show what that management was. Besides, there were no other sections of the statute, the Court held, which in express terms authorized the commissions to require the creation of a depreciation fund.

It was further held, that while the power of the commissions was extensive, and should be so construed, yet the exercise of a particular power by the commissions should have its basis "in the language of the statute or should be necessarily implied therefrom." The assertion of authority here under review was held to be "outside of and beyond the statute."

It is for this very reason that such extensive, and even minute, authority is given to the Commission with regard to other matters, that I am unable to spell out implied authority to do that which the Commission has undertaken to do here. If the Legislature had desired to invest the Public Service Commission with power to prescribe what amortization funds should be taken out of income, it could have done so very simply and in a few words. That it did not do so, is suggestive that it did not intend to confer such power."

[19] People ex rel. New York Railways Company et al. v. Public Service Commission, 223 N. Y. 373. Decided May 14, 1918.

PART THREE

ADDITIONAL CAPITALIZATION FOR EXISTING COMPANIES

Under Part III we shall consider the issues involved in applications by existing companies for additional capitalization. The most important of these issues have been the proper handling of replacements, retirements of property, depreciation, amortization, equitable selling prices for bonds [and, in some cases, of stock] and a fair rate of return upon securities, the latter two subjects being closely related. Besides these there have been adopted various emergency measures either to meet money market conditions or weakened credit in the individual company, as the case may be. These issues are involved in the cases considered in the other chapters, but special consideration has been given to them here because they occur to a much larger extent in cases dealing with applications for additional capitalization.

Part III has been divided into five chapters under which have been discussed, in connection with cases pertinent thereto, (1) the important factors considered in granting additional capitalization; (2) the selling prices of and rate of return upon securities; (3) the amortization of intangible elements entering into capitalization, (4) depreciation and replacement, and, (5) finally, a number of miscellaneous considerations which are of interest and which do not seem to fall into any general category.

CHAPTER VIII

General Factors Considered

The first matter of additional capitalization to come before the Second District Commission was an application[1] of the Hudson River Electric Power Company for leave to issue bonds to an amount of $3,232,000 under a mortgage for $30,000,000 executed by the Company. The purpose was the erection of a storage and power dam, electrical power plant, and transmission lines in connection therewith.

The following considerations[2] the commission set down for this and similar cases of application for leave to issue additional capital:

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[1] Matter of Application of the Hudson River Electric Power Company, 1 P.S.C.R., 2nd Dist., N. Y. 51. Decided December 4, 1907.

[2] *Definiteness in Applications for Securities*

In a case where an applicant corporation applied for consent to the issuance of a consolidated mortgage for $1,000,000, the application stated merely that the bonds issued thereunder should run for not more than one hundred years and that the rate of interest thereon should not exceed five per cent.

(1) The purpose to which the proceeds arising from the sale of the securities are to be applied.

(2) The amount reasonably necessary for the consummation of such purposes.

(3) The character of the securities proposed to be issued.

(4) Whether any proposed construction or extension is likely to create unhealthful conditions or otherwise constitute a public nuisance, infringe upon the vested rights or impede the necessary operations of other public service corporations, or interfere with the flow of water in a navigable stream to the extent of impairing its public use.

The commission held that these matters were not expressed with sufficient definiteness, and directed the applicant to present its financial plans in detail, including a copy of the mortgage actually intended to be issued and specifying the number of years for which the mortgage was to run, the rate of interest to be paid on the bonds provided for in such mortgage, and the price at which they were to be sold. Matter of Application of the Greenwich and Johnsonville Railway Company, 1 P.S.C.R., 2nd Dist., N. Y. 90. Decided February 18, 1908.

Similarly in an application of the Third Avenue Railway Company for approval of an issue of bonds, it appeared upon the hearing of the application that the specific purposes for which the money obtained by the issue of the bonds was to be used were not shown; that the amount of bonds to be issued and sold was not given; and that it was the intention of the applicant to finance a part of its proposed expenditures (the purchase of securities of a competing railroad company) by the issue of notes maturing not more than a year from date and that no bonds would immediately be issued for such purpose. It was held that under such circumstances the application for the approval of a bond issue was premature and could not be acted upon without more specific data. Matter of Application of Third Avenue Railway Company, 3 P.S.C.R., 1st Dist., N. Y., 327. Opinion adopted June 28, 1912.

Ample Time for Investigation of Proposed Issues Necessary

During the first few years of the Commissions' existence, many applicants for the issue of bonds made such insistent requests for speedy action as to give the impression that they thought authorization should be granted immediately. In view of the intricacies of many of the cases submitted, the Second District Commission in connection with an application of the Delaware and Hudson Railroad Company (1 P.S.C.R., 2nd Dist., N. Y., 242. Decided July 7, 1908), called attention to the fact that while it desired to dispose of all proceedings as promptly as possible, yet, if to facilitate the financial operations of applicants, such as taking advantage of immediate conditions in the bond market, or of prices of commodities, a thorough investigation should be omitted, and it should virtually be assumed by the Commission on the basis of a superficial examination that the capital to be secured was reasonably required, in so doing the Commission would be acting in utter disregard of its prescribed statutory duty.

"It must be understood" the Second District Commission stated in the above case, "that in the interests of the stockholders as owners of the property sought to be mortgaged and those who have money to invest, as well as of the general public, the proposed issues will be carefully scrutinized and that all time necessary to examination, consideration and determination will be used."

(5) Whether there is reasonable prospect of fair return upon the investment proposed, to the end that securities having apparent worth but actually little or no value may not be issued with our sanction.[3]

In passing upon the application the Commission considered:

The extensions proposed by the applicant and the purposes to which they were to be applied.

The estimate of cost.[4]

The general financial condition of the applicant, individually, and in connection with the financial situation of its subsidiary companies.

The important provisions of the mortgage under which the bonds covered by the application were intended to be issued.[5]

The Commission took the general position that in passing upon the proposed issue of bonds under this application, no approval or disapproval was intended to be expressed as to the remainder of the bonds covered by the mortgage; that if the issuance of any portion of the bonds covered by this application was sanctioned, such sanction carried with it no implication of consent upon a future application as to any of the remaining bonds embraced in the mortgage, and that a determination upon any such future application would not be considered as in any wise affected.

In connection with the application[6] for a bond issue, the First District Commission, after a thorough investigation of the books and records of the applicant corporation, decided to approve of an issue of $625,000, face value, of bonds out of a total of $740,000 applied for, upon the following grounds:

1. An inventory and appraisal of the property of the company by the engineers of the Commission showed beyond question that the present value of the physical assets less depreciation considerably exceeded the face value of the proposed issue.

2. The applicant had always paid its interest (the majority of the proposed issue was for the purpose of refunding outstanding bonds) and there had been a profit every year after paying operating expenses, taxes and fixed charges.

3. The area of supply was steadily increasing in population and the amount of gas and electricity supplied was growing.

4. The proportion of current sold for street lighting as compared with private lighting was decreasing, which was a favorable sign.

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[3] See application of Hudson River Electric Power Company. 1 P.S.C.R., 2nd Dist., N. Y., page 67.

[4] In view of certain deductions arrived at in the Commission's investigation, $3,000,000 was considered sufficient instead of the $3,232,000 asked for.

[5] See Application of Hudson River Electric Power Company, supra, page 66.

[6] Matter of the Application of the Bronx Gas and Electric Company, 2 P.S.C.R., 1st Dist., N.Y., 150. Opinion adopted November 12, 1909.

CHAPTER IX

SELLING PRICES OF SECURITIES AND RATE OF RETURN

The Commissions of New York state have, in the main, endeavored to limit the return upon the securities of utility corporations to a reasonable basis. Consequently, if bond discount is to be regarded by the Commissions as interest paid in advance to be amortized in annual payments within the life of the bonds, it follows that the bonds should be sold at as high a price as possible. It is obvious that the lower the price at which a bond is sold the higher will be the fixed charges upon it. A bond bearing a reasonably low rate of interest may be sold low enough to yield an unreasonably high rate. Bonds have often been disposed of privately by an issuing company at a price so low as to net favored parties a higher yield than would have been necessary if they had been offered to the public.

The Commissions, realizing the difficulty of themselves fixing the price accurately, have generally stipulated that the public be given an opportunity to bid, as is often done in the case of municipal bonds. In some cases the Commissions have arbitrarily fixed what they deemed to be a fair price. Likewise the stock of certain corporations may be worth in the market much more than par, and the disposal of it at par to present stockholders may give them a profit which should rightfully go to the corporation itself.

Stringency in the money market may make necessary high rates of return which it would not be justifiable to incur over a long period such as would be the case with long term bonds or with cumulative preferred stock. In the latter case, indeed, the charge would be perpetual. Such exigencies are generally met by means of short term notes.

Finally, a corporation may have its property so encumbered that its credit is exhausted. Nevertheless, it may be in urgent need of new equipment to meet reasonable demands of the public service, demands which it is the prime duty of a commission to enforce. In such a case resort is had to "car-trust certificates" or "equipment notes." Under these forms of securities the title to the property involved, that is, the units of equipment purchased with the proceeds of the notes, rests with the creditors, as represented by their trustee, until payment is completed.

Public Offering Made a Test of Market Value of Bonds

The Bronx Gas and Electric Company, in connection with an applica-

tion[1] for authorization from the First District Commission to issue certain bonds, requested permission to sell the bonds to a private banking house at 90. A representative of the banking house admitted that they expected to sell them at 95 or more. The Commission held that it would not approve the issuance of the bonds at such a figure unless a sale at public letting to which all could have access should show that 90 was the full market value of the bonds.[2]

In its approval of an application[3] made by the Kings County Lighting Company for authorization of an issue of bonds to the amount of $200,000 for needed extensions to plant, the First District Commission granted the permission asked, but stipulated in its order that these 5 per cent debenture bonds might be sold at private sale at not less than par after payment of all commissions and expenses. The applicant subsequently asked that this minimum be revised to 97½, and the Commission agreed.

[1] Matter of the Application of the Bronx Gas and Electric Company, 2 P.S.C.R., 1st Dist., N. Y., 178. Opinion adopted January 14, 1910.

[2] The Order form stipulating that securities be offered at Public sale is quoted herewith (see Rules of Procedure and Regulations Public Service Commission 1st Dist., N. Y., page 29).

"CLAUSE 7, PUBLIC SALE OF SECURITIES

"Second, That no (bonds) [notes, etc.] authorized hereunder shall be sold by the company for less than . . . (—) per cent of par with interest accrued thereon, unless the same shall be first offered to public subscription, as herein provided. Whenever the company shall desire to sell (bonds) [notes, etc.] issued hereunder except for not less than . . . (—) per cent of par and accrued interest, the treasurer of the company shall invite proposals for the purchase of such (bonds) [notes, etc.] by public advertisement for not less than once a week for four successive weeks in at least four daily newspapers published in the City of New York and shall award the same to the highest bidder therefor. The said proposals shall only be publicly opened by the treasurer of the company and in the presence of the Public Service Commissioners for the First District or such of them as shall attend at the time and place specified in such public advertisement. It shall be a condition of said sale (and the advertisement calling for proposals therefore shall so declare) that any bidder may bid for all or none of said bonds at one price, or for all or any portion at one price, or for portions at different prices, and any bidder who shall bid for the portion of said (bonds) [notes, etc.] may be required to accept a part of the portion bid for by him at the same rate as may be specified in his bid, and any bid which conflicts with this condition may be rejected; and if the board of directors deem it to be in the interest of the company so to do, they may award the (bonds) [notes etc.] to the bidder offering the highest price for all or a number of the said (bonds)]notes, etc.] and provided also that if the board of directors deem it to be in the interest of the company they may reject all bids. The board of directors may prescribe other conditions incident to and providing for the proposal for the purchase of (bonds) [notes, etc.] as it may see fit."

[3] Matter of Application of the Kings County Lighting Company, 1 P.S.C.R., 1st Dist., N. Y., 700. Opinion adopted July 2, 1909.

In the matter of the application[4] of the Hudson River and Eastern Traction Company, which was described on page 64, issuance of 5 per cent bonds at 80, as asked by the petitioner, was approved, but in this case the risk was considered so great that the Second District Commission endeavored to deny moral responsibility for the whole proceeding, although a higher price for the proposed bonds would have been ridiculous in view of the risk involved.

In the case of the application[5] of the Rochester Corning Elmira Traction Company, the Second District Commission stipulated that the 5 per cent bonds there proposed should not be disposed of at less than 85. The Commission based its approval of the issue of the securities in this case upon a thorough investigation and seemed to consider the proposed project to be reasonably sure of success.

In the case of an application of the New York and Ontario Power Company, the applicant corporation proposed to issue 5 per cent bonds at 80, and the Second District Commission stipulated 81, stating that this price was not out of keeping with a new proposition of this character.[6]

These instances go to show that the Commissions, in fixing the prices of bond issues themselves can, at best, merely feel their way and base their conclusions upon the relative amount of risk, price of money, and similar factors.

Possibility of Bonds Being Worth More Than Par

Kings County Electric Light and Power Company applied for approval of an issue of $5,000,000 convertible debenture bonds to be sold at par. In view of the prosperous condition of the company, however, objection was made to allowing the applicant to sell the securities at par, as it was felt that they were worth more, and that the company, rather than the purchasers, should have the benefit.[7] It appeared that the prospect that the present stockholders would be allowed to subscribe for the debentures at par had raised the market value of the stock. Therefore, it was argued, the debentures must be worth more than par. It was pointed out that, in 1901, when the financial stability of the company was much

[4] Matter of Application of the Hudson River and Eastern Traction Company, 3 P.S.C.R., 2nd Dist., N. Y., 172. Decides December 27, 1911.

[5] Matter of Application of the Rochester Corning Elmira, Traction Company, 1 P.S.C.R., 2nd Dist., N. Y., 166. Decided March 30, 1908.

[6] Matter of Application by the New York and Ontario Power Company 1 P.S.C.R. 2nd Dist., N. Y., 453. Decided January 14, 1909.

[7] Matter of Application of the King's County Electric Light and Power Company, 2P.S.C.R., 1st Dist., N. Y., 193. Opinion adopted January 24, 1910.

less pronounced, a small lot of stock offered to the public had brought over 140. These debentures, it was argued, were even preferable to the stock, inasmuch as they gave the holder the option of the safety of bonds or of conversion into stock if the circumstances warranted. Therefore, the company should obtain as high a price as possible. The bonds were, however, allowed to be offered at par.

The same question was involved in the application[8] of the Astoria Company for permission to issue $9,500,000 additional common stock, and first mortgage bonds to the amount of $5,000,000 with an interest rate of 5½ per cent. This was an unusual return upon first mortgage bonds of a corporation of such unquestioned stability, and the matter caused a division of opinion in the First District Commission.

It was claimed, upon the part of the company, that as the bonds would retire 6 per cent obligations the plan would effect a reduction in fixed charges. This reason seemed weak in view of the difference in the nature of notes and long-time bonds. The exigencies of the money market were advanced as justification, and sundry bonds of railroads and public utilities selling on such a basis were cited in support of the reasonableness of the proposed rate.

Commissioner Maltbie objected vigorously to the issue of 50 year, first mortgage bonds at 5½ per cent when based upon such unquestioned security as underlay these proposed bonds. He pointed to the fact that no mortgage bonds issued by any company now comprised in the Consolidated Gas system (the applicant was a subsidiary of the Consolidated Gas Company) bore a higher rate than 5 per cent and that none of such bonds were quoted below par.

A bond closely resembling the Astoria bond, the dissenting opinion held, was the 5 per cent first consolidated mortgage bond of the Brooklyn Union Gas Company, which was selling for more than par. The proposed bonds of the Astoria Company represented only one-third of an investment that was paying substantial dividends to the stockholders of the Consolidated Gas Company. The latter had made a joint application to be allowed to take over the securities applied for, and hence there would be no commissions or other expenses attendant upon the marketing of the bonds. This seemed to be a reason for approval in the minds of those who favored the 5½ per cent rate. Commissioner Maltbie pointed out[8] that if 5 per cent bonds similarly situated could be sold at par or above, and these 5½ per cent bonds were to be taken over by the Con-

[8] Matter of Application of the Astoria Light, Heat and Power Company, 5 P.S. C.R., 1st Dist., N. Y., 122. Opinions filed March 3, 1914.

solidated Gas Company at par, they could be sold by the latter at a premium of 8 or 10 points, netting $400,000 or $500,000 with which to pay dividends that had not been earned from the manufacture and sale of gas. Moreover, the dissenting opinion contended, approval of a rate of 5½ per cent could be used in future rate cases as the basis of an argument as to the necessary cost of obtaining money for public service enterprises. For, to quote from the minority opinion,

> if a public utility could cite the commission's approval of a first mortgage bond covering only one-third of the investment in a $15,000,000 plant, and nevertheless carrying a 5½ per cent interest charge, it might argue that a fair rate of return on the whole property, including the risk assumed by stockholders, should greatly exceed the 6 per cent that was conceded by the Supreme Court as sufficient in the 80-cent case.[9]

Therefore, the dissenting opinion held, the Commission could not properly certify that an issue of $5,000,000 50-year, 5½ per cent bonds for the refunding of obligations amounting to $5,000,000 was "reasonably required," as laid down under the capitalization sections of the Public Service Commissions Law.[10] The bonds were, however, allowed to be issued at par.

In another instance the Consolidated Gas Company of New York City applied for permission to issue $25,000,000 of 6 per cent convertible debentures and $25,000,000 of additional common stock for the purpose of the conversion.[11] The proceeds were to be applied to the reimbursement of monies expended from income or other funds in the treasury of the company. The authorization asked for was given, but Commissioner Maltbie objected upon the ground that the issuing of these $25,000,000 debentures, convertible after three years and due after five years, was not "reasonably required for the purposes specified." This was due to the fact that the debentures had a market value of from 110 to 115. Therefore, there would be required from $2,300,000 to $3,250,000 less than the $25,000,000. If the selling price of bonds had to be reduced in some cases as low as 20 below par to meet the conditions of the money market, and, perhaps, a lack of confidence in the security underlying the bonds in specific cases, why, the Commissioner argued, should not the rule work the other way, too? And where a company's credit was so good as to cause securities to sell above par, such conditions it was claimed, should

[9] Willcox et al., vs. The Consolidated Gas Company, 212 U. S. 19. Decided January 4, 1909. See pages 49 and 50 of this opinion.

[10] See sections 55, 69, 82 and 101. Chapter 480, Laws of 1910.

[11] Matter of Application of the Consolidated Gas Company of New York City. 5 P.S.C.R., 1st Dist., N. Y., 339. Opinion filed December 18, 1914.

be made to benefit the company itself and not stockholders or debenture holders in their capacity as individuals. In other words, par was less than a fair value, and was, therefore, exorbitant to the company. As with the Astoria bonds, the plan here involved seemed susceptible of giving a chance for a ten-point profit which would not be derived from the legitimate business of the company.

The attitude of the New York Commissions, especially of the First District Commission, may be said to have been very liberal towards public service corporations in the matter of the issue prices of securities.

High Rate of Return Due to Temporary Necessity Should Not be Made Permanent

In the case of the application of the Newburgh Light, Heat and Power Company, the Second District Commission refused to permit the alleged exigencies of the money market to be used as an excuse for an abnormally high rate of return in perpetuity.[12] The Newburgh Company applied for permission to increase its capital stock from $500,000 to $750,000, and to classify the capital stock so increased into $500,000 of common stock and $250,000 of 8 per cent cumulative preferred stock. Of course, what this request really amounted to was an issue of $250,000 of 8 per cent cumulative preferred stock in addition to the outstanding $500,000 of common stock.

The Commission was convinced that the purposes to which the capital was to be applied were within the law, that such capital was "reasonably required" for such purposes, and that the present earning power warranted the expectation that it could easily meet the return upon the new issue in addition to the dividends on the present stock.

The application was denied because the Commission regarded the interest rate as unreasonably high. It was stock, and therefore, perpetual, as the dividends were to be cumulative. The Commission expressed itself as follows:

> An issue of $250,000 eight per cent cumulative preferred stock would create a permanent annual charge of $20,000 upon the property, and, in our judgment, allowance of a permanent fixed charge of this character to meet temporary exigencies of the money market is not justified. The distinction between a continuing capital burden of that description and an issue of bonds or notes for a short term, bearing a fair rate of interest, even if sold at a moderate discount, is obvious. Favorable action upon this petition would constitute a precedent which, if followed in other cases, might

[12] Matter of Application of the Newburgh Light, Heat and Power Company, 1 P.S.C.R., 2nd Dist., N. Y., 7. Decided August, 21, 1907.

operate disastrously to minority stockholders, and also work hardship upon affected communities through the continuous necessity for service rates or charges sufficiently high to meet such permanent obligations.[13]

About a year later, the same company made a second application, this time for leave to issue ten-year convertible bonds (convertible into common stock), bearing interest at 8 per cent, to the amount of $350,000.[14]

The applicant had made further investments in plant since the previous application, and this accounted for the increase asked for. The Commission, after investigation by its engineers, made certain reductions in the detailed estimate of expenditures submitted, and held that $330,000 would be sufficient. It was felt that the objections made to the former application had here been met, as the issue of bonds was for a comparatively short term. Their convertibility into common stock the Commission did not view as objectionable, as they were to be sold for par. The Commission expressly stipulated that any conversion of these bonds into stock, after the expiration of two years and before maturity, should take place upon a particular day, and after thirty day's notice to bondholders, in order that those desiring might avail themselves of the privilege. It was further stipulated that, preliminary to any such conversions, the formal approval of the Commission must be obtained upon application in writing by the Company, so that any issue of stock should be made upon the express authorization of the Commission.

The Commission felt that existing market prices of securities justified 8 per cent on a ten-year bond, as this was equivalent in yield to a 5 per cent ten-year bond at 80 or a 6 per cent ten-year bond at 86.4.

The 8 per cent preferred cumulative stock asked for in the previous application would have been equal to a perpetual 8 per cent bond, except, of course, that default of interest would not have thrown the company in to receiver's hands. The result to the rate-paying public would have been the same, as a Commission would feel obliged to adjust rates to meet charges upon securities of which it had itself approved. On the other hand, the bonds, even if carried to maturity as such, ran for a comparatively limited period, and if converted into stock in the mean time would not have a stated or a cumulative charge, as they could only be converted into common stock.

[13] See 1 P.S.C.R., 2nd Dist. N. Y., bottom page 8.

[14] Matter of Application of the Newburgh Light, Heat and Power Company, 1 P.S.C.R., 2nd Dist. N. Y., 210. Decided April 29, 1908.

Bonds Used as a Basis for Short Term Notes

An application of the Coney Island and Brooklyn Railroad Company for approval of an issue of short-term notes based upon bonds brought up an interesting method of meeting temporary exigencies of the money market. Upon an application for authority to issue bonds for new construction, it appeared that the bonds proposed to be issued were 4 per cent bonds, to be issued under a mortgage executed in 1904 under the approval of the Board of Railroad Commissioners.[15] The purpose for which the proceeds were proposed to be used were such as were contemplated in that mortgage. The property of the company was, however, held under that mortgage and it did not seem practicable for this occasion to pledge other property of the company to raise the required funds. On the other hand, such 4 per cent bonds could not be disposed of at more than 80. It was held that "in view of the necessity of the case and of the great public need of this improvement" the bonds should be authorized to be sold, at not less than 80, and the discount amortized within the life of the bonds.

The company, however, after obtaining permission to sell the bonds at 80, came to the conclusion that this would be too much of a sacrifice, and a plan was evolved of using said bonds on a basis of 80 as security for the issue of three-year 6 per cent notes, the holder of the bonds to be allowed to take them over at 85, if he so desired, or the company to redeem the notes at 101, and thus release the bonds. The Company hoped that by thus issuing notes to meet the urgent need of funds, there would be secured an opportunity within the three-year life of the notes to sell and dispose of the bonds at a better price than 80. For $500,000 of notes, $625,000 of bonds were to be pledged. This plan met with the approval of the Commission.[16]

Car Trust Bonds Used in Case of Weakened Credit

This form of security is used very generally in those cases in which a corporation has already exhausted the usual resources of its credit and finds itself unable to take title to new property (or equipment) which it does not as yet own.

In 1908 the Coney Island and Brooklyn Railroad Company had been directed by the First District Commission to acquire ten new cars, but

[15] Matter of Application of the Coney Island and Brooklyn Railroad Company, 2 P.S.C.R., 1st Dist., N. Y., 336. Opinion adopted July 29, 1910.

[16] Matter of Application of the Coney Island and Brooklyn Railroad Company, 2 P.S.C.R., 1st Dist., N. Y., 481. Opinion adopted December 30, 1910.

did not have sufficient funds on hand to carry through the purchase. Under an existing mortgage, it could, with the approval of the Commission, issue 4 per cent bonds, but the condition of the money market made the use of such bonds extravagant, as long-term bonds sold at a heavy discount would mean high interest for a long period. Accordingly, it applied for approval of an issue of $30,000 of 6 per cent gold "car-trust bonds," to be sold at not less than par.[17] They were not to constitute a lien upon the assets of the company, or to be secured by any mortgage thereon. The payments by the company upon the cars were to be considered as rental, and the title of the cars was to remain in the trustee until the final payment had been made. The cars were to be marked "Brooklyn Trust Company, Lessor," and the contract further provided a method of substitution in the event of their destruction while in the possession of the operating company. Also, in case the company should default in payments or fail to keep the cars in good condition, or perform any of the other stipulations in the contract, the trustee could declare the agreement terminated and all installments of rent would become due and payable, and the trustee could enter upon the premises of the railroad and retake the said cars. In view of the condition of the money market and the urgent necessity of having the cars, the Commission approved the application. In case the bonds sold for more than par, the premium was to go to the applicant.

Similarly, in 1914, the Staten Island Company applied for consent to issue equipment trust 6 per cent certificates to the amount of $135,000, to be paid off within ten years in semi-annual installments.[18] The manufacturer of the cars was to assign title in them to the Bankers Trust Company. The latter would then subscribe to the certificates and the Railway Company would get no title to the cars until the certificates were paid. It appeared that some such plan was the only means by which the applicant could obtain new equipment, as interest on its first mortgage bonds had not been paid for some years, and the mortgage contained an "after acquired" clause which would prevent the company from borrowing money on the cars if title were to vest in the company.

In addition to the certificates, $35,000 in cash was to be paid upon delivery of the cars. There was a question as to how much of the new

[17] Matter of Application of the Coney Island and Brooklyn Railroad Company, 1 P.S.C.R., 1st Dist., N. Y., 113. Opinion adopted February 18, 1908.

[18] Matter of Application of the Staten Island Midland Railway Company, 5 P.S.C.R., 1st Dist., N. Y., 345. Opinion adopted December 22, 1914.

capital should be charged to "Capital Account," and how much to "Replacements." This phase of the application has been fully discussed elsewhere under the heading of "Replacements." (See page 108.)

Funding of Bond Interest to Meet Credit Emergency

The Erie Railroad, in order to meet an exigency due to the overburdened condition of the corporation's credit, presented to the Second District Commission a plan for procuring funds by funding the interest upon certain bond-issues for a period of five years.[19]

The general opinion seemed to be that the Erie had great possibilities, but it had always been handicapped by large fixed charges, due partly to heavy bond issues, and partly to high operating expenses resulting from an inefficiently built road. Thus, it had always had to steer between Scylla and Charybdis, doing fairly well in periods of prosperity, but encountering serious difficulties with the first approach of 'hard times.' The bond issues must take their natural course, but the management had always felt that the high operating expenses could be greatly reduced if sufficient improvements were made to the system. The difficulty was to get the needed capital. In view of the former vicious management of its capitalization, additional securities issued seemed out of the question, except as a temporary emergency measure.

The only remaining resource was earnings, and these were heavily eaten into each year by a combination of fixed charges and large operating expenses. The heavy fixed charges consumed that part of net earnings which might have been devoted to a reconstruction of certain parts of the road, and which would have resulted in a consequent reduction in operating expenses. On the other hand, the high operating expenses prevented any acceleration in the liquidation of the corporation's heavy indebtedness.

The only element in the situation that offered a direct gain was an increase in net income through increased efficiency. This could be effected only through the investment of large sums in the reconstruction of parts of the physical system. If a substantial portion of the fixed charges could be escaped for a period of years, and the amount involved put into the road, a large saving in operating expense could be effected. With the idea of breaking the vicious circle, the management of the Erie submitted their plan for the approval of the Commission.

During the year 1908 the Erie had suffered a disastrous strike, as a result of which that year showed a deficit of over a million and a half

[19] The Matter of Application of Erie Railroad Company, 1 P.S.C.R., 2nd Dist., N. Y., 471. Decided March 2, 1909.

of dollars as compared with surpluses of from four and a half to six millions in previous years. Its condition was considered so acute that the Commission, as an emergency measure, gave permission for the issuance of 6 per cent notes to the extent of $15,000,000 to run not to exceed five years. These notes had been issued for three years, and at the time of this application, (1909) would soon mature, and, in addition, large improvements but partially completed would require heavy expenditures. On the other hand, the business depression resulting from the panic of 1907 still continued to seriously affect net income.

The plan involved approval of an issue of $30,000,000, 5 per cent bonds, to mature in not over thirty years. Of the authorized issue of notes mentioned above, $10,500,000 had already been put out. For notes already issued, and such additional part of the issue as should hereafter be sold, the plan proposed to exchange these bonds when it was deemed advisable, thus avoiding the early maturity involved in the notes.

The semi-annual interest coupons of the applicant's 4 per cent convertible and general lien bonds would amount, during the ensuing five years, to $11,380,000. The company's idea was to temporarily fund this interest by exchanging an amount of the proposed bonds equal in face value to the amount of the coupons; but upon condition that the collateral trust indenture under which the bonds were to be issued and the Commission's order should

provide for the expenditure by the company from income each year of the said five years an amount upon improvements of the property equal to the face value of the coupons falling due semi-annually under the convertible and general lien bond issues, thereby causing the extension of the interest debt to cease one-fifth each year and so render such proposed bonds to the extent of one-fifth each year to be for improvement of the property.[20]

Thus, at the end of five years the bonds so exchanged for coupons would not represent funded interest at all, but capital actually expended for improvements. The remaining bonds were to be sold for not less than 87½ for the purpose of improvements and betterments or for the discharge of bonds or equipment obligations maturing in the near future.

Another general condition was that the aggregate of notes outstanding under the $15,000,000 authorization, and the bonds issued under the indenture under consideration should not exceed the $30,000,000 specified in the latter. If the remainder of the authorized notes were issued, the remaining amount of bonds to be sold would be that much less.

[20] See 1 P.S.C.R., 2nd Dist., N.Y., bottom of page 474.

The proposed scheme would have resulted in an increase of the company's funded debt by $30,000,000. To offset this there would be the following advantages:

(1) The funding of the short term notes which could be issued up to $15,000,000.

(2) The funding of $11,380,000 of interest which would accrue during the next five years on two subordinate mortgage liens.

(3) The proposed expenditure of the remaining bonds (the amount depending upon the notes issued) for the improvements and betterments.

In regard to the second item, it should be pointed out that as the interest became due semi-annually, the expending from income of at least an equal amount upon improvements and betterments would constitute a proper subject of capitalization. In other words, the funding of the interest debt would, at the end of the five-year period, have been transformed into additional capital. The interest payments of which the company would be relieved amounted to $2,276,000 per year. From this there had to be subtracted interest at 5 per cent upon the new bonds devoted to the funding purposes. The average amount of such interest would bring the net temporary relief afforded to $1,707,000 per year.

It was felt that, while the company might manage to get along without such relief, radical steps would be justified to place it upon a sounder financial basis. The corporation labored in a slough of over-capitalization which rendered its general condition and its credit precarious with the first approach of business depression. The only remedy seemed to lie in some plan of financial re-adjustment which would enable it to pay from income for a number of years the cost of a series of additions and improvements to its road-bed for the purpose of decreasing operating costs. The corporation would then be able to build up a surplus to carry it over lean times, and could gradually, it was hoped, extricate itself from its over-burdened financial condition.

The Commission held that any plan involving the funding of bond-interest upon the part of a public service corporation should be summarily rejected, unless specific conditions were attached which would warrant such unusual financing. In the present case, however, it was held that in view of the merits of the individual case, the purposes for which the capital was to be used were within those enumerated in the Law, and were also 'reasonably required.'

The collateral indenture was to provide "for the setting aside each six months and the use for the described improvements and additions within three months thereafter of monies taken from income equal to

the amount of interest funded which would have accrued during the six months period." The same restriction was also to apply to any interest funded by the issue of additional notes. This plan was never put into actual practice because of the difficulty of getting individual bondholders to agree to it.

CHAPTER X

Amortization

The term amortization in the strict sense is generally applied to the setting aside of funds to offset those items entering into capitalization which represent no physical value. The amounts of such items are, in most cases, known definitely in advance, and hence, amortization can be computed much more definitely than in the case of depreciation, where an approximate estimate is the best that can be done. It includes such items as, for instance, bond discount, interest during construction period, expenses of marketing securities, excess capitalization and promoter's fees. The term amortization is, however, often used in a general way to cover liquidation of loss upon physical value as well as upon intangibles.

Amortization of Bond Discount

The New York Commissions have made it a general rule that bond discount should be amortized within the life of the bonds. This has been one of the important reforms achieved by commission rule in New York state. Not that bond discount was not amortized in many cases before the advent of the commissions, but that the latter made it a fundamental rule and enforced it uniformly. For this reason we have not made mention of ordinary cases of amortization, as it is provided for in the ordinary procedure of granting approval. The order form for the First District Commission is as follows:

> Fourth: That all discounts, commissions and expenses in connection with the approval, issuance and sale of the said (bonds) (notes, etc.) authorized to be issued under this order not to exceed . . . dollars ($——) shall be amortized out of the income of the company before the . . . day of . . . 19—, by the payment of (a monthly) (an annual) installment, so long as may be necessary, of an amount not less than . . . , such (monthly) (annual) installment to begin . . . "[1]

The report of the Railroad Securities Commission to President Taft (November 1911) refers to the subject as follows:

> It seems to be generally agreed that no limitation should be placed on the price at which bonds can be sold, but any discount should be cancelled or amortized during the life of the bonds by appropriation each year out of annual income or surplus accumulated after the issue of the bonds of not less than the proportional amount of the discount.[2]

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[1] Rules of Procedure and Regulations, etc. Public Service Commission, First District N. Y., page 30.

[2] See 62nd Congress—Second Session 1911-12, House Documents, Vol. 139. Document No. 256. Report of the Railroad Securities Commission. See Section 21, bottom of page 26.

The Commissions have viewed bond discount in the nature of interest paid in advance which must be paid off year by year just the same as the regular interest.

Little opposition to the systematic amortization of bond discount was met with on the part of the companies, but one example of an attempt to circumvent the requirement is worthy of notice. This was the application of the New York Railways Company to purchase stock of the Twenty-third Street Railway Company by the issue of bonds.[3]

On January 1, 1912, the New York Railways Company, which is a reorganization of the Metropolitan Street Railway Company, took over a lease of the 23rd Street Railway Company. By the adoption of this lease the rental payable thereunder became a charge upon the former. The terms of the lease provided for a rental of 18 per cent upon the par value of the company's capital stock which consisted of 6,000 shares of $100 par value, or $108,000 per annum, and also provided for organization expenses of the leased company, which amounted to about $1500 per year. If this 18 per cent had gone directly to the 23rd Street stockholders as dividends, the value of the stock, or rather its capitalization upon the terms of the lease, would have been about 360. This, however, was rental paid to the 23rd Street Railway Company, and such portion thereof as was, in the judgment of the directors of the company, applicable to the payment of dividends, was then distributed to the stockholders of the company. As a result, the dividends received were considerably below 18 per cent, due to the fact that a considerable amount was usually retained by the Company for litigation, franchise-tax payments, etc. The actual market value of the stock, based upon the rate of return, seemed to be, therefore, from $250 to $280 per share.

The New York Railways Company desired permission to purchase the stock of the 23rd Street Company. Of the 6,000 shares outstanding 4,305 could be purchased immediately, and the remainder from time to time as opportunity offered. The plan submitted provided for payment for the stock in 4 per cent bonds of the applicant, allowing bonds to the amount of $350.00 for each share ($100 par value) of stock. This plan, the applicant claimed, would save them $24,000 per year in rental and $1500 annually in expense of keeping up the organization of the leased company. Four per cent upon $350 of bonds gives, of course, 14 per cent, as compared with the 18 per cent under the lease, or a saving of $4 per share, or, on 6,000 shares, $24,000 per annum. The 4 per cent

[3] Matter of Application of the New York Railways Company, 5 P.S.C.R., 1st Dist., N. Y., 293. Opinion adopted October 30, 1914.

bonds of the New York Railways Company were selling in the market for from 75 to 80, and upon this basis, $350, par value, of bonds for one share of stock, would place upon the stock a value of from $260 to $280.

Instead of issuing its bond at from 75 to 80 and using the proceeds to purchase the stock at market value, the applicant proposed to trade $350 of bonds for a share of stock, and this was the proposition to which the Commission objected. For such a plan would permit the company to avoid the amortization of the bond discount involved. The company insisted that if such amortization was required by the Commission, it would give up the proposed plan. On the other hand, as the Commission pointed out, if the bonds had been sold at 75 to 80 and the proceeds used to purchase the stock, there would have been no question as to the necessity for amortizing the 20 to 25 per cent discount within the life of the bonds, since it was fundamental that under all proper methods of financial procedure it was incumbent upon a company to amortize discount upon bonds during a period not exceeding the life of the bonds.

Besides, as the Commission pointed out in the opinion, "the establishment of an amortization fund does not deprive the company of any property. It is merely the setting aside of a fund which will be available to retire part of the bonds when they become due."

The defiant attitude of the company and its threatened refusal to carry through the purchase of the stock if amortization were required, was based upon fictitious reasoning. It assumed, to quote from the opinion, "that a purchaser has been found who is willing to pay $350 for a share of stock having a market value of from $250 to $280; that persons have been found who are willing to sell stock for $265 per share that is worth $350; and that a purchaser has been found who will pay $,1000 for a 4 per cent bond of the New York Railways Company which has a market value of from $750 to $800."[4] The Commission felt that approval of such a scheme would establish a precedent which could be used to overthrow the whole amortization policy. If 4 per cent bonds were to be issued at 80 to buy—say, a car costing $4,800, the Commission would permit a company to issue the necessary $6,000 par value of bonds, but would require the establishment of a fund which, with accruals, would amount to the difference of $1,200 by the date of maturity of the bonds. Such has been, and is the settled policy of both Commissions.

If the application in the present case were allowed, however, a company could come to the Commission and say simply that it proposed to

[4] See 5 P.S.C.R., 1st Dist., N. Y., bottom of page 305.

buy a $4,800 car with six bonds at par. In other words, instead of having the bonds issued for cash they would be exchanged for property, the conversion into cash taking place between the car manufacturer and a brokerage house. This part of the transaction would not come before the Commission at all. As a result, the car would be capitalized at $6,000 without the provision of any fund to amortize the difference between the actual value of the bonds and the par value due at maturity. The proposition was disapproved and the applicant informed that the settled policy of the Commission in the matter of amortization must be adhered to.

Amortization of Property Subject to Reversion

The Third Avenue Railroad Company, in March 1909, made application for approval of the issue of certain securities which were to be based on an extension to its road to be constructed under a franchise just granted by the city.[5] According to the terms of this franchise the grant might be terminated by the city at any time after March, 1912, subject to a possible extension by the city for two years more. This arrangement would make necessary the amortization of bonds within three years, and would call for the setting aside of one-third of the cost each year from earnings. The Commission held that as in this case the extension was very short (two-thirds of a mile) in proportion to the length of the system of which it was a part, the amount to be amortized would not be so large as to create a serious burden upon the system, but that, if the principle were to be applied to a long extension or a large system, it would be difficult for the line to operate. The result would probably be high fares and poor service, as the corporation would endeavor to shift such an unreasonable burden to the public. The application was granted.

The Coney Island and Brooklyn Railroad Company applied for permission to issue bonds upon a property subject to reversion to the city under franchise provision.[6] The company's tenure of the property was terminable upon three months' notice, and, in such case no payment need be made by the city. The Commission felt that under such circumstances the cost of this part of the construction should not be permanently capitalized, but should be met out of earnings.

[5] Matter of Application of the Third Avenue Railroad Company, 1 P.S.C.R., 1st Dist., N. Y., 512. Opinion adopted March 26, 1909.

[6] Matter of Application of the Coney Island and Brooklyn Railroad Company, 2 P.S.C.R., 1st Dist., N. Y., 336. Opinion adopted July 29, 1910.

In view, however, of the fact that the company had already put large amounts of earnings into work properly chargeable to capital, bonds were allowed to be issued upon condition that they be paid off in twenty years by the sinking fund method.

Similar requirements for the amortization of intangible assets and assets whose value expired with the expiration of a franchise were made in connection with the application of the Third Avenue Bridge Company for authority to issue stock. This was a case of an original company. It had already obtained permission to issue $20,000 par value of stock upon the condition that all proposed expenditures must receive the approval of the Commission before being paid out of the proceeds of the securities authorized.[7]

About a month later the Company presented a list of proposed expenditures amounting to $14,940, which were duly audited by the Commission and found to be proper capital charges. The list, as presented, is given herewith.[8]

(1) Organization	$395.88
(2) Franchise	100.00
(3) Other intangible street railway capital	11,005.90
(4) Right of way	1,240.62
(5) Taxes during construction	1,050.00
(6) Interest during construction	1,048.33
(7) Special deposit (under terms of franchise)	100.00
	$14,940.73

None of these items related to any physical property, and all but (1), (4), and (7) represented rights or expenses connected with such rights which would terminate in 1934 when the franchise expired. As there was no provision for its renewal, the company's investment in these rights would be without value at the termination of the franchise. Even if the company should obtain a renewal of the franchise or a new franchise, it would be put to new expense, and none of the expenditures already made in connection with the present franchise, except for property owners' consents, would be of any value. For example, Item (3) was made up principally of advertisement of franchises and legal services amounting to over $10,000.

[7] Matter of Application of the Third Avenue Bridge Company for an Order Authorizing an issue of $20,000, par value, of its capital stock. 2 P.S.C.R., 1st Dist., N. Y., 779. Opinion adopted December 30, 1911.

[8] Matter of Application of the Third Avenue Bridge Company for authorization of an issue of stock, 3 P.S.C.R., 1st Dist., N. Y., 209. Opinion adopted March 8, 1912.

The Commission ruled, therefore, that it was incumbent upon the company to provide for the amortization of all expenses relating directly or indirectly to the franchise and other rights which would cease to be of value when the franchise expired. The only part of the investment represented by the above expenditures that would have value after 1934 would be the company's certificate of incorporation, the certificate of convenience and necessity, property owners' consents for the present route, and special deposit.

The items thus requiring amortization totaled $13,345. The Commission, accordingly, attached to its Order consenting to the withdrawal of the funds a condition that the company establish and maintain an amortization fund with an annual contribution of at least $300 plus 4 per cent upon prior contributions until the fund amounted to the value of the assets which had a limited term of life, as given above.[9]

The Third Avenue Bridge Company did not accept the order and about a year later applied for a re-hearing, urging that the amortization requirement be set aside.[10] At the same time it asked for permission to give a note to the Third Avenue Railway Company for approximately $93,000 to cover monies advanced by the latter for capital expenditures (for construction purposes) other than those met out of stock proceeds. The claim for setting aside of the amortization requirement was based upon the contention that a large part of the construction, such as switches and short connecting tracks with intersecting lines, were of permanent value. A further reinvestigation, however, showed that all were covered by the terms of the franchise and would revert to the city at the expiration of the franchise without any payment, and, accordingly, the Commission held, the cost of all property which would revert to the city must be amortized prior to the date of reversion.

Practically all the items of expenditures authorized to be paid from the proceeds of the sale of stock, and also the expenditures involved in

[9] The same issue occurred in connection with the application of the Third Avenue Railway Company to acquire certain shares of stock of the Third Avenue Bridge Company. The Commission approved the issue of the stock by the latter upon condition that the cost of its franchise should be amortized during the term thereof. The Bridge Company had not as yet stated whether it would comply with the amortization order. The Commission held that in view of this there was a question as to whether the said stock had been legally issued, and if it had been issued except in compliance with the order of the Commission, the latter could not properly authorize its purchase by the Third Avenue Railway. Matter of Application of the Third Avenue Railway Company, 3 P.S.C.R., 1st Dist., N. Y., 327. Opinion adopted June 28, 1912.

[10] Matter of Application of the Third Avenue Bridge Company for Authorization of Stock Issue. 6 P.S.C.R., N. Y., 189. Opinion filed March 23, 1915.

the proposed note, related to assets which would have no value at the expiration of the franchise, and therefore permission to make the note, as in the case of the stock, was based upon the condition that appropriate arrangements be established and maintained for the amortization of the same.[11]

Amortization of Excess Capitalization

In March 1914, there was completed in the First District a case involving the reduction of a corporation's fixed capital account to a basis of actual value. This case was ideal in that it demonstrated a practical arrangement for wiping excess capitalization off a corporation's books in a gradual way.

The Brooklyn Borough Gas Company had made application for approval of an issue of $125,000 of additional capital stock.[12] The company had just completed a new gas holder at a cost of $160,000. Of this amount $16,000 had been taken from the depreciation reserve to cover the amount of replacements included in the gross expenditure, and $19,000 from earnings, leaving $125,000 to be raised by the sale of additional stock.

In acquiring its original property in 1898, the applicant had issued bonds to the amount of $240,000 and stock to the amount of $500,000. The investment in the property, however, according to the Commission's opinion, could not have exceeded $250,000. According to the opinion "practically the whole issue of stock ($500,000) represented a capitalization of anticipated profits, often called the value of franchise."

The applicant company had paid no dividend up to December 31, 1913, but had devoted all its surplus earnings to the building up of its property. Its area of supply had been developing rapidly and the demand for extensions had been large. Additional capitalization to the amount of $760,000 had been issued. This brought the bonded debt up to $1,000,000 making the total capitalization, including a proposed issue of $125,000 of additional stock, amount to $1,625,000, as represented by the par value of the securities. The fixed capital (property investment) account, as of January 1, 1914, stood at $1,773,100.

The need for a revision of the company's fixed capital account first appeared in connection with a rate case in which it was found that the capitalization of the company greatly exceeded the fair value of its

[11] See Matter of Application of the New York Dock Railway, 4 P.S.C.R., 1st Dist., N. Y., 94. Opinion Adopted March 28, 1913. See pages 101 & 102.

[12] Matter of Application of the Brooklyn Borough Gas Company, 5 P.S.C.R., 1st Dist., N. Y., 203. Opinion adopted March 13, 1914.

property.[13] It was not then necessary to fix the value, and the exact amount of the excess was not ascertained. In a subsequent case brought two years later the Commission found that the fixed capital account was about $450,000 in excess of the then fair value of the fixed property.[14]

For some time the Commission had urged upon the company the wisdom of a revision of its fixed capital account and had pointed out the advantages which would accrue to the applicant company in the matter of future financing. When the application for additional stock had come up the matter was again brought to the company's attention and it had agreed to a plan satisfactory to the Commission.

The Commission's appraisal of the property, as of January 1, 1914, had been about $1,500,000 on a basis of reproduction new, and this, less accrued depreciation, amounted to $1,344,700. The difference between this amount and the company's fixed capital account, $1,773,180, was $428,000, which was represented largely by old works which had been superseded by new, and which, therefore, came under the head of replacements. Concerning the status of these old works, the Commission held that "the old works might have been regarded as a reserve plant so long as the new works were not in complete and successful operation, but when that time arrived the old works served no purpose other than room for storage of supplies. Their value, aside from the value of the land, was virtually nil, and the company agreed that it was improper to carry the original cost of the old plant as an asset."

The company agreed to revise its asset-accounts and write off the excess of capitalization over present value by the continued investment of surplus earnings in additional property. The plan which was accepted by both the applicant company and the Commission was as follows: of the excess in fixed capital account of $428,428, there was to be immediately charged off to surplus $178,428. This left $250,000 which was to be carried as a suspense account on the company's balance sheet under the title of "Franchise and other intangible assets in process of amortization." Each year there were to be reserved from earnings over and above the reservation for depreciation 5 cents for each thousand

[13] In the matter of the Complaint of Edward G. Baltz and others against the Brooklyn Borough Gas Company and in the Kings County Lightning Company. Also, Matter of the Rates Charged by the Brooklyn Borough Gas Company, etc., 2 P.S.C.R., 1st Dist., N. Y., 620. Opinions adopted August 18, 1911.

[14] Matter of the Hearing on the Motion of the Commission upon the Question of the Rates and charges of the Brooklyn Borough Gas Company, etc. 4 P.S.C.R., 1st Dist., N. Y., 328. Opinion adopted July 8, 1913.

cubic feet of gas sold, such amount to be invested in extensions and additions so that in eight or ten years an equality would have been established between the actual value and the nominal capitalization of the company.

Importance of Complete Record of Property Costs

An important result of the adoption of such a plan was the obtaining of a complete record of cost of the company's property. In the cases of corporations coming into existence since the adoption of the uniform system of accounts prescribed by the Commission, the cost of all property purchased with the proceeds of securities, other than evidences of indebtedness for twelve months or less, has been automatically recorded. Thus, when a car, engine, boiler, gas main or meter is retired from service, the amount added to the capital of a corporation at the time of acquisition can be deducted from the fixed capital account and parity preserved between property and capitalization.

Where a corporation had existed prior to the installation of the uniform system of accounts, there are, in many cases, no itemized records of the cost of the different units of property. Consequently, when any such units are abandoned, there is always disagreement as to the amount that should properly be deducted from capital account. As the majority of corporations coming under the jurisdiction of the Commissions had existed prior to the creation of the latter, the inadequacy of the cost-records, that is, the retirement-value, of the units of a company's plant, caused great difficulty in the regulation of capitalization.

In the present case one great advantage from the point of view of the Commission was the establishment of a permanent record of retirement value of every unit of the company's property, for, so far as the Brooklyn Borough Gas Company was concerned, the company and the Commission had agreed upon a detailed inventory and appraisal of the amount at which each unit of property stood in the fixed capital account. This inventory could be kept up-to-date with a minimum of effort. By means of it a rate investigation, if one were necessary, could be made very quickly. In addition, the company would be enabled to present to banking-houses and investors a balance-sheet approved by the Commission.

It should be noted that, owing to the rate cases referred to, the returns received by the company prior to this application were based upon the fair value of the property. The Commission's plan for an additional amortization fund, therefore, came from the company's legitimate share

in the enterprise and not from any increase, direct or indirect, in the price of gas. Thus it was possible in this case to eliminate gradually the excess capitalization without placing any additional burden upon the consumer. This was the first company in the State to adopt such a plan voluntarily, and, in the words of the First District Commission, "to realize that a statement of assets based upon present values of tangible property and the amortization of excessive capitalization will attract investors and stimulate confidence in banking circles.[15]

Difficulty of Fixing Value of Retirements Without Cost Records

Similar issues were involved in the application of the New York Edison Company for approval of an issue of additional stock to the amount of $15,800,000.[16] The Consolidated Gas Company owned all the outstanding stock of the New York Edison Company. Since 1907 it had advanced to the Edison Company upon promissory notes sums of money for improvements and extensions. The expenditures of these funds for capital purposes had been verified by the engineers of the Commission to the amount of $23,000,000. During this period retirements amounting to $4,000,000 had been credited to capital account at the cash cost, or where that was not obtainable, at the estimated cost, leaving net additions of $19,000,000.

The retirements of property added to capital since 1907 and retired since that time were found to be correctly charged and credited, but a question arose as to an item of $1,745,733 of retirements of property of the corporation acquired prior to that time. No record of the actual amount at which these units of property were originally written into capital could be found.

When the Edison Company was reorganized in 1901, $9,000,000 par value of the stock of a predecessor company had been taken over on a basis of $220 per share, or a total value of $20,240,000. At the same time the Edison Company had issued $45,000,000 of its own stock, which represented nothing more than 'monopoly value,' as Charles E. Hughes expressed it during the investigation of gas and electric rates in New York City in 1905. This represented an inflation of some $56,000,000. The records of the company showed the cost of capital installed since its organization in May, 1901, but did not show any detailed distribution of

[15] For a copy of the order in this case see Matter of Application of the Brooklyn Borough Gas Company, 5 P.S.C.R., 1st Dist., N. Y., 203.

[16] Matter of Application of the New York Edison Company, 5 P.S.C.R., 1st Dist., N. Y., 132. Opinions filed March 3, 1914.

the items of capital or even of the groups installed by predecessor companies and taken over by the Edison in 1901. Retirements of such capital had been written off by the company at their estimated cash cost, but it seemed that this capital had originally been put upon the books of the Edison Company at about three times the actual cash cost. The company refused to give the Commission's representatives access to the original books of entry and refused to furnish them a copy of the opening entries. It did furnish a trial balance taken after the opening entries of May 1, 1901. A comparison of this trial balance with the schedule of physical assets acquired by the company from predecessor companies as furnished to the Legislative Committee of 1905 showed that assets aggregating $26,743,666.54 were taken into the Edison Company's account, "Plant and Property" at $81,688,645.60.

In other words, when the books of the newly organized Edison Company were opened, the capital account was made to balance the inflated liabilities then issued, irrespective of the original cost of the property acquired. The difference between the two figures quoted above is practically identical with the inflation produced by the purchase of $9,200,000 par value of stock at 220, and the issue of $45,000,000 of stock of the new company.

The books of the company furnished no segregation of these large intangible values, and it was the opinion of Commissioner Maltbie that until they did, retirements of the old capital should be written off as proportionate parts of this $81,000,000. In this case the retirements for property installed prior to May 1, 1901, amounted to $1,745,751.95, or 6.53 per cent of the cash cost of all the "old capital." The same proportion of the total cost of this property to the Edison Company ($81,688,445) would be some $5,334,268, or three times the figure used by the company in writing off the retirements. Chairman McCall in approving the application, stated his position as follows:

> We do not believe that the Commission has the power to impose as a condition for authorizing the issue of securities for the purpose of refunding obligations in accordance with Section 69 of the Public Service Commissions Law, that the applicant Company shall write down its capital account because of alleged capitalization of some of its intangible assets in the remote past.[17]

Of course, it would make no actual difference in the decision of this case whether said item of retirements were charged off at three times the value or not. Nor would it decrease the stockholders equity or take any money from them. It would simply reduce capital account on one

[17] See 5 P.S.C.R., 1st Dist., N. Y., bottom page 136.

side and depreciation reserve or surplus, as the case might be, on the other side of the balance sheet, and in the case of surplus would make that much less available for dividends. As to Chairman McCall's statement just quoted above, to the effect that the Commission did not have power to impose as a condition of the issue of securities for refunding purposes the writing down of the capital account as outlined, and Commissioner Maltbie's contention that it did have such power, we might say that this is still a mooted question, and has never been tested before the courts.

The plan adopted in the Brooklyn Borough case presents a feasible method of eliminating excess capitalization which had originated before the taking effect of the Public Service Commissions Law. On the other hand, under the method pursued in the New York Edison case such excess capitalization will never be eliminated, and a return in perpetuity will have to be paid upon it.

CHAPTER XI

Depreciation and Replacements

Depreciation is generally defined as a lessening in value of physical property due to wear and tear, age, decay, obsolescence, and changes in methods brought about by new inventions and discoveries. In actual practice, however, well-managed corporations meet wear and tear as a current operating expense under the head of maintenance. It is hard to draw the line between maintenance and depreciation. For instance, the renewal of brake-shoes is maintenance, while the renewal of rails is properly met from depreciation funds. It is for this reason that commissions frequently class maintenance and depreciation under a blanket requirement, as was done by the New York First District Commission in the case of the reorganized Third Avenue Railway Company, and in that of the New York Railways Company, also based upon a reorganization.[1] Under this procedure the necessary requirements for maintenance are withdrawn, and the remainder is credited to the depreciation fund. The results of depreciation other than that commonly classed as maintenance must be provided for by the accumulation of a fund. If such a fund is not accumulated the day will come when the corporation will be faced with the alternatives of financing the results of depreciation, that is, replacements, from the proceeds of additional capitalization, or of being unable to function properly in the public service. The second alternative means bankruptcy and a reorganization, and the first, if it be possible to carry it out, is merely a wasteful postponement of the second.

Additional capital used for replacement purposes increases the amount of liabilities without increasing the amount of assets correspondingly, and thereby produces excess capitalization. On the other hand, where property is abandoned, and is not subsequently replaced, the liabilities remain as before, while the assets are correspondingly diminished in amount unless the amount of property retired is credited to the capital account. Thus the capitalization of a corporation may be inflated either by sins of omission, or of commission; either by neglect to accumulate

[1] Matter of Plan for Reorganization of the Metropolitan Street Railway Company, 3 P.S.C.R., 1st Dist., N. Y., 113. Opinion adopted February 27, 1912. See page 131, also 152, (et seq.) of the opinion.

See also Matter of Application of Bondholder's Committee of the Third Avenue Railway Company, 3 P.S.C.R., 1st Dist., N. Y., 51. Opinion adopted February 3, 1912. See bottom page 57; section 3. Also pages 58 and 59.

a depreciation fund and the consequent financing of replacements out of additional capital, known as the capitalization of replacements, or by failure to credit retirements.

Depreciation and the capitalization of replacements cannot be considered separately. They are like the two sides of a shield; one is the cause and the other the result. In a depreciated property without depreciation funds to care for it we have the accomplished fact, while in regularly setting aside funds for depreciation we are preparing to meet the contingency. In the setting aside of depreciation funds, which we could just as properly call replacement-funds, we have the opposite of the proposition involved in the capitalization of replacements. And, since it has been decided that the New York State Commissions do not have the power to approve the issuance of securities for the financing of replacements it would seem to be an illogical proposition if they lacked the power to enforce the setting aside of proper reserves for depreciation (or replacements) if the purpose of their creation was, as has been said by the Appellate Division,[2] "to provide protection for the investing and travelling public." The cost of replacements is operating expense just as much as is the cost of wages or supplies. The need for replacements is inevitable, and if their financing cannot be met from current income or depreciation reserve accumulated from income, additional capital must be secured. In cases where the emergency seems to justify it, the New York State Commissions, under the authority granted by the Public Service Commissions Law, may, at their discretion, permit the issue of bonds for that purpose. Such permission, however, is almost always granted upon condition of rapid amortization of the bonds so issued.

In any case, the capitalization of replacements has the effect of increasing liabilities without any corresponding increase in assets. It is a practice which will lead straight to financial suicide if indulged in to any extent. To replace practically an entire plant in this way, and such instances are by no means rare, would be to double capitalization without increasing power of production.

Depreciation

A very important part of the work of the New York State Commissions has consisted in their efforts to make corporations realize the iniquity of the capitalizing of replacements, and the necessity of setting

[2] People ex rel. New York Railways Co. vs. Public Service Commission, 181 App. Div. N. Y., 338. Decided January 18, 1918.

aside sufficient funds to meet depreciation. In numerous cases involving the levying of taxes the necessity of depreciation funds had been emphasized and supported by the courts prior to the creation of the Public Service Commissions. It should be borne in mind, however, that this was a lefthanded kind of support, and that the courts, in emphasizing the necessity of setting aside depreciation funds in cases of contested taxes, were really favoring the interests of the corporations involved, inasmuch as deductions from income meant lower taxes.

Be that as it may, some of these judicial views upon the necessity of providing for depreciation will shed light upon the present discussion. The Public Service Commissions, of course, support depreciation as a means of protecting the original investment, thereby protecting the investing public against loss, and the consuming public against unreasonable rates based upon inflated capitalization, or impairment of services due to the throes of reorganization.

In a leading tax case in the State of New York the Court of Appeals held as follows:

> We suppose that judicial notice may be taken of the fact that in the conduct of many industrial enterprises there is a constant deterioration of the plant which is not made good by ordinary repairs, which, of course, operates continually to lessen the value of the tangible property which it affects. The amount of this depreciation differs in different enterprises, but the annual rate is usually capable of estimate and proof by skilled witnesses. No corporation would be regarded as well conducted which did not make some provision for the necessity of ultimately replacing the property thus suffering deterioration.[3]

When the same case was before the Appelate Division of the Supreme Court, the latter had held that

> the net income of a corporation for dividend purposes cannot be determined until all taxes, depreciation, maintenance and up-keep expenditures have been deducted. Otherwise the dividend is not paid from the earnings but by a depreciation of the capital account. To earn a dividend and be honest with itself, its stockholders, its creditors and the public it has to serve, a corporation cannot distribute earnings at the expense of its capital.[4]

In another case before the Appellate Division it was held that:

> The annual ordinary expenditures for repairs, replacements and renewals upon such a property cannot be assumed to make it unnecessary to provide a fund which

[3] People ex rel. Jamaica Water Supply Company vs. Tax Commissioners, 196 N. Y. 39. Decided October 19, 1909. See pages 57, 58.

[4] Same before Supreme Court, 128 App. Div., 13. Decided September 17, 1908. See pages 17, 18.

will replace its engines, electrical equipment and other physical property which at some time must be replaced.[5]

The attitude of the United States Supreme Court in the Knoxville Water case supports the same principle and is quoted from as follows:

> It (the company) is entitled to see that from earnings the value of the property invested is kept unimpaired so that at the end of any given term of years the original investment remains as it was at the beginning. It is not only the right of the company to make such a provision, but it is its duty to its bond and stockholders, and, in the case of a public service corporation at least, its plain duty to the public. If a different course were pursued, the only method of providing for replacement of property which has ceased to be useful would be the investment of new capital and the issue of new bonds or stocks. This course would lead to a constantly increasing variance between present value and bond and stock capitalization—a tendency which would inevitably lead to disaster either to the stockholders or to the public or to both. If, however, a company fails to perform this plain duty and to exact sufficient returns to keep the investment unimpaired, whether this is the result of unwarranted dividends upon over issues of securities, or of omission to exact proper prices for the output, the fault is its own.[6]

In the Binghamton case[7] the Court of Appeals held that even without the specific reference to capitalization of replacements contained in the 1910 amendment to the Public Service Commissions Law it was the duty of the Commission "to determine whether the stock and bonds proposed by the relator were to secure money to pay floating indebtedness incurred in the ordinary running expenses of the corporation."

In the Delaware and Hudson case the court had charged the Commission with substituting its judgment for that of the directors in the management of the affairs of the applicant corporation, but the determination of the nature of the expenditure above referred to, the Court declared, would not constitute such a substitution of judgment upon the part of the Commissions. To quote from the decision:

> at least if the directors of the company had wholly and intentionally ignored the self-evident proposition that except for special and extraordinary circumstances some part of the expenses of renewing machines and plant originally charged to capital account must be paid as a part of the operating expenses of a corporation from year to year. We refer to the necessity of a corporation providing for some part of the expenses of renewing machinery and plant from year to year as self-evident, because it has been so considered and expressed by the courts in many cases.[8]

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[5] People ex rel. Third Avenue R. R. Co. vs. Tax Commissioners, 136 App. Div. 155. Decided December 30, 1909. See page 159.

[6] City of Knoxville v. Knoxville Water Co., 212 U. S. 1. Decided January 4, 1909.

[7] People ex rel Binghamton Light, Heat and Power Co. vs. Stevens, 203 N. Y., 7. Decided October 3, 1911.

[8] People ex rel. the Delaware and Hudson Co. vs. Stevens, 197 N. Y. 1. Decided December 7. 1909.

During the early years of the Commissions instances of neglect of depreciation were by no means rare. In the case of the application of the Kings County Lighting Company for authorization of an issue of bonds, an investigation of the affairs of the company by the First District Commission showed that while earnings had been used to enlarge the plant, they had not been so used to any extent.[9] On the other hand, no depreciation reserve had been set aside prior to January first of the year under consideration, when such a fund had been started by order of the Commission.

It was essential, the Commission ruled, that the company henceforth use its earnings to build up its plant, or accumulate a fund for so doing, before the payment of any dividends.

In a rate case against the Coney Island and Brooklyn Railroad Company, the Commission took occasion to point out that for a number of years the company had been accustomed to distribute all its surplus earnings in dividends, while no provision had been made for depreciation, and appropriations for maintenance had been very inadequate.[10]

In view of the need for rehabilitating the road, it would not reduce fares, but would, on the other hand, see that necessary replacements were paid for out of earnings before dividends were considered. The position was taken that no calculation of the cost of service of a public utility is satisfactory which omits proper charges for deterioration of the physical property. Allowance must be made for wear and tear that is not currently repairable, and for growing inadequacy of equipment which has to be replaced before it is worn out.

Replacements

In connection with an application of the Staten Island Midland Railway Company for permission to issue equipment trust certificates for the purchase of new cars which were badly needed to replace old ones, the question arose as to how much of the proposed expenditures would represent capital and how much should properly be charged to replacements.[11]

An investigation of the applicant's equipment by the engineers of the Commission showed that twenty of its cars were so far worn out that

[9] Matter of Application of the Kings County Lighting Company, 1 P.S.C.R., 1st Dist., N. Y. 700. Opinions adopted July 2, 1909.

[10] Matter of Complaints against the Coney Island and Brooklyn Railroad Company, 1 P.S.C.R., 1st Dist., N. Y., 705. Opinion adopted July 2, 1909.

[11] Matter of Application of the Staten Island Midland Railway Company, 5 P.S.C.R., 1st Dist., N. Y., 345. Opinion adopted December 22, 1914.

it was unsafe to use them, and that it would not pay to repair them. The proposed new cars were to cost $172,000, of which $135,000 was to be met by the issue of a like amount of equipment trust certificates, and the remaining $37,000 by cash paid out of income. The old cars were charged upon the books at $63,680. This amount, therefore, less the $37,000 cash proposed to be paid from income, left $26,680 as the replacement charge to be written off the capital account, or else paid out of current income as rapidly as possible.

About a month later the applicant asked for a rehearing in order to present proof that the old cars mentioned above could be repaired, put into good operating condition, and used. The rehearing was granted, and the engineering staff of the Commission also offered evidence showing which twenty of the cars of the company it was that were in such bad condition, and identified them by number and a description of the electrical equipment of each car.[12] As a result the Commission amended its previous order so as to certify that the proposed expenditure out of the proceeds of the $135,000 of equipment trust certificates was reasonably chargeable to capital, and so as to authorize the issuance of the certificates upon condition that, if the applicant did not overhaul and put into first-class, serviceable, operating condition certain of its cars by a specified date (this date allowing about five months), then there should be deducted from the capital charge authorized by reason of the acquisition of the additional cars an amount equal to the book-value less the selling price or scrap-value, as the case might be, of the cars which it was proposed to overhaul. The elasticity of this arrangement permitted the corporation to make the most of its old cars without in any way tying the hands of the Commission in the matter of preventing the capitalization of replacements.

An application of the New York Railways Company involved similar conditions.[13] The company applied for permission to issue its 4 per cent bonds under an existing mortgage to an amount sufficient to provide $1,600,000 to be used for the acquisition of 175 new stepless cars at approximately $6,000 per car, and $550,000 for the reconstruction of the 54th Street car barn.

These 175 new cars were not to constitute additional equipment, but for each new car purchased an old one was to be retired from service,

[12] Matter of Rehearing upon the Application of the Staten Island Midland Railway Company, 6 P.S.C.R., 1st Dist., N.Y., 1. Opinion Adopted January 22, 1915.

[13] Matter of Application of New York Railways Company, 3 P.S.C.R., 1st Dist., N. Y., 397. Opinion adopted November 1, 1912.

so that when all the new cars had been installed the number of cars in use would be the same as before. When the proposal was criticised the company claimed that they should be allowed to capitalize at least the difference between the cost of the new cars and the present value of the old ones. The value of the latter was estimated by the company at from $250 to $1,000 per car, depending upon the market which could be found for them. Upon an average value of $600 the company would be capitalizing $5,400 for each new car, resulting in the financing of replacements by new capital issues.

The New York Railways Company, the applicant, was a reorganization of the Metropolitan system, and it now sought to justify this alleged capitalization of replacements by claiming that, in acquiring its system, it had purchased the property at its present value, and that the applicant's capitalization represented present value and not original cost. Hence, it would be proper to credit capital account with the present value of the old cars ($250 to $1,000) and charge capital account with the entire cost of the new car, $6,000.

The objection to this argument was the finding of the Commission in the reorganization proceedings to the effect that the capitalization of the said New York Railways Company exceeded the value of the property by at least $16,500,000.[14] In this case (the reorganization), the expert witness of the Bondholder's Committee had claimed that value was equivalent to cost to reproduce-new, and that the value of the old cars now to be removed was over $3,700 per car. This estimate was part of the evidence upon which the Bondholder's Committee had justified the capitalization of the new company (the present applicant). In the same proceedings the Commission's engineer had submitted an estimate of $822 per car. If a value of say, in round numbers, $800 had been accepted in the reorganization as the capitalization-value of the old cars, the company could have properly been allowed to capitalize the difference between the cost of the new car ($6,000) and the capitalized value ($800) of the old, a difference of $5,200, and such an addition to capital would have been represented by actual property.

In the Brooklyn Union Gas case, previously discussed, the Commission had pointed out that one of the great advantages of the plan adopted by the company was the complete inventorying of each item of the property. This was of especial importance when old property or equipment

[14] Matter of the Plan for Reorganization of the Metropolitan Street Railway Company, 3 P.S.C.R., 1st Dist., N. Y., 113. Opinion adopted February 27, 1912. See page 181.

was to be retired, and this ideal condition was compared with the lack of detailed information existing in the accounts of most corporations, and the resultant differences of opinion between the Commission and the corporation when old property was retired. Of the lack of any such detailed inventory the books of the present applicant formed a good example, as its property and equipment was represented upon its books by a lump sum entry of $74,384,737.10. The cars in question were not carried at any specific amount; they were lost in the one entry of over $74,000,000. Logically, if the applicant wished to continue the plan for which it sought approval in this case, that is, the capitalization of replacements at the difference between the present, actual value of the old and the cost of the new, the first step would be a detailed distribution of this item of over $74,000,000 into the various classes of property which it owned, at their value. The suggestion was incidentally thrown out by the Commission that such an attempt, in view of the excess of capitalization over value, would involve many difficulties, and would probably leave a large balance which would have to be charged to some such account as "Other Intangible Street Railway Capital," representing such items as franchises, "good will," and "going concern."

One argument advanced by the applicant was to the effect that the old cars were still capable of much service and that the company was justified in retiring them only in an effort to improve the quality of service rendered to the public; hence such improvement should be paid for by the public by the issue of bonds; and, further, that the payment of interest on the company's income bonds should not be interfered with by a requirement that replacements be paid out of earnings and not out of capital.

Such an argument, the Commission felt, would apply to all replacement and maintenance charges. It would apply to the whole system; and when one cycle of replacements had been completed, the company would have only one plant, but would owe for two—the one which had disappeared and the one which existed, and the balance sheet would indicate that the company owned twice the property which it actually did own. Logically, the process would not stop with one cycle, and "bond issue may be piled upon bond issue without a corresponding increase in its property."

In the words of the opinion:

The end of such financiering may be easily imagined, but it need not be left to the imagination. The results are too well known from the experience through which the street railway lines in Manhattan have just passed. They were bad service, dilapi-

dated plant and equipment, high operating expenses, judgments, receiverships, foreclosure, heavy assessments or loss of property, stockholders closed out, bonds paid off below par value, all corporations brought under suspicion, capital for legitimate enterprises obtained with difficulty, etc. Yet the very corporation which was reared upon the ruins of the Metropolitan system now comes before the Commission and asks that we fix the stamp of our approval upon the very practice which caused or aided the disruption of the Metropolitan system. It was to be supposed that something had been learned from experience. The capitalization of operating charges must stop and replacements are operating charges.[15]

The company also urged that, because it had no funds with which to pay the cost of replacing these old cars, the taking of the necessary funds from earnings would prevent the payment of interest on the income bonds, and that this should not be interfered with. If interest could not be paid upon the bonds without capitalizing replacements, the blame lay, they argued, not with the Commission or the public, but with those who made the reorganization necessary.

The Commission pointed out, in reply to this, that the plan of reorganization had not been approved by it, and had been carried through regardless of its finding that the proposed capitalization was far in excess of the value of the property, and that probably earnings would not meet operating charges, interest on first mortgage bonds, and the five per cent on income bonds. Hence, it was held, if the company, in spite of the warning of the Commission, had issued bonds upon which it could not truthfully earn interest, it must accept the consequences. In any case, the Commission held, the company could not legally pay interest on income bonds until it had provided for replacements. The Commission had taken the position from the beginning, it stated, that capital must be kept intact out of earnings, and that provision must be made for depreciation and the ultimate replacement of all wasting assets.

As a matter of fact, the company for its first six months of operation after the reorganization had declared as earned and payable on income bonds interest to the amount of 7.71 per cent, as compared with the 5 per cent stipulated in the bonds. The company, therefore, the Commission pointed out, could not plead poverty as a reason for the approval of a bond-issue when it was paying out to holders of income-bonds money which it should have retained for the purposes covered in the application. "The Commission," the opinion held, "had no legal power to authorize the issue of bonds for replacements."

[15] Matter of Application of New York Railways Company, 3 P.S.C.R., 1st Dist., N. Y., 397. See page 407.

This principle was specifically upheld by the New York State Court of Appeals in the Binghamton case, which is discussed later.

In regard to the carrying through of the reorganization plan of the Metropolitan Company in spite of the disapproval of the Commission, it should be explained that between the handing down of the decision of the Court of Appeals in the Third Avenue case and the amendment of the reorganization section of the Public Service Commissions Law in 1912, there was a period of a year or more during which the New York State Commissions felt compelled, in reorganization cases, to give official sanction to reorganization plans presented by applicant corporations or bondholders' committees which were in excess of the value of the property involved. The reorganization of the Metropolitan Company came before the First District Commission during this period. The issue of bonds for the purchase of new cars would have been denied in whole, except for one factor, and that was that the new cars were of greater capacity and would cost much more than the cars to be replaced had cost originally.

Hence, the Commission proceeded upon the basis that the cost of the new cars, to the extent of these two factors, would not be a replacement. In this connection the Commission enumerated three standards by which to determine the amount which might be capitalized under such conditions, as follows:

1. Estimated cost-to-reproduce-new of the old cars as compared with the new.
2. Relative capacity.
3. Relative cost.

In the Reorganization case, referred to above, the cost-to-reproduce-new of these cars had been estimated by the company at $3,768, and by the Commission at $3,376. As the capitalization was based upon the company's estimates, this would leave not more than $2,232 to be capitalized upon a $6,000 car.

As to relative capacity, the old car seated 28 persons—the new car, 51. As standing room was practically the same, this gave a ratio of 28 to 51, leaving 23/51 of $6,000, or $2,706, which could properly be capitalized.

The third standard would be ideal when accounts had been kept correctly and showed actual original cost. In this case no complete cost records existed, and such as there were showed a partial cost of $2,398. Upon these partial records it was estimated that each car had cost from $3,100 to $3,200, leaving, on a basis of $6,000 for the new cars, $2,800 or $2,900 to be capitalized. Replacements, betterments, retirements and depreciation as relating to street railways were fully treated in the uni-

form system of accounts prescribed in 1908, and in accordance with these provisions, and the circumstances outlined above, it was decided to permit the capitalization of $2,800 per car on a basis of $6,000 cost per car for the new cars. It should be stated that the relative seating capacities of the old and new cars was used as one test only because of the lack of data. Cost should be the real test wherever possible.

The remainder of the amount applied for in this case it was proposed to devote to the reconstruction of a car-barn. This latter work was expected to cost $550,000 and consisted in the addition of two stories and a new roof. The company also owned a block of property used for the storage of cars. These premises the company had arranged to sell for $1,750,000 of which $50,000 had been paid. The sale, however, was not consummated as yet. The property was subject to a mortgage of $950,000, leaving $800,000 available if the transaction was completed. It was felt by the Commission that the sale of the property and the reconstruction of the car-barn were closely related, as the addition of the floors to the barn would take the place of the storage facilities of the property to be sold, and the one would be a replacement of the other and therefore, could not properly be capitalized.

The New York Railways Company soon after applied for and was granted a rehearing upon the order as it affected the issue of bonds for new cars.[16] The applicant company failed, however, to produce any additional arguments to support its previous contentions.[17]

[16] Matter of Rehearing of Application of New York Railways Company for Authority to Issue Bonds, 5 P.S.C.R., 1st Dist., N. Y., 92. Opinion adopted February 6, 1914.

[17] In the interval between these two hearings there had been rendered a decision by the United States Supreme Court which seemed to fit the case under consideration. This was the decision in Kansas City Southern Railway Co. vs. United States et al., decided December 1, 1913, (231 U. S. 423).

The Commission, in its opinion relative to the rehearing which it had granted, quoted at length from this decision. It seemed that the Kansas City Southern had desired to reduce certain grades in its lines, and thought it best to do this by building tracks off from the original line in some instances, the corresponding sections of old track being abandoned upon completion of the new. The full cost of this new construction it sought to charge to the account of "Additions and Betterments," a subdivision of its capital account. Under the requirements of the uniform system of accounts prescribed by the Interstate Commerce Commission, however, when improvements or betterments involved the abandonment of tracks which were already charged to capital account, the cost of "replacing in kind" the abandoned or replaced tracks must be charged to operating expenses, so that nothing more than the element of betterment should be added to capital account. Thus, for instance, if an 80-lb.

A Uniform System of Accounts Can Permit of No Exceptions

As discussed under "Refunding and Reorganization," the Commission found, at the time of the Metropolitan reorganization, that the proposed capitalization exceeded the value of the property by at least $16,500,000. Being compelled under the circumstances to give its consent, it included a requirement to the effect that the said excess should be amortized. It later became doubtful of its authority to enforce such a provision and withdrew it.

The present applicant, being the reorganized Metropolitan Company, contended that the refusal of the Commission to permit it to capitalize substantially the entire cost of the new cars was tantamount to a reinstatement of the amortization order which had been withdrawn. The Commission pointed out, however, that the amortization order had required the company to provide for the difference between *the then value* of the property and *the amount of capitalization*, while the order in the present case simply required the company, when units of property were retired from service, to provide for the difference between the selling-price or scrap-value and the amount at which the property stood upon the books of the company by other means than by the use of additional capital, as such would constitute capitalization of replacements. The Commission stated that because it was without power to make this general amortization order at the time of the reorganization of the

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rail were substituted for a 60-lb. rail, the estimated cost of installing the latter should be charged to operating expense and only the additional cost of the heavier rail charged to capital account. The company regarded this requirement as unreasonable and illegal, but the Supreme Court upheld the power of the Commission to make such a ruling and the reasonableness of such a requirement.

"The contention of the applicant," the United States Supreme Court had held, "that property, originally acquired because necessary in the construction of the road and development of the property and afterwards abandoned only because rendered unnecessary by the improvements should remain in the property account as a part of the stockholders' investment, will be found, upon analysis, to rest upon the unwarrantable assumption that all capital expenditures result in permanent accretions to the property of the company. This in effect ignores depreciation—an inevitable fact which no system of accounts can properly ignore. A more complete depreciation than that which is represented by a part of the original plant that through destruction or obsolescence has actually perished as useful property, it would be difficult to imagine."

As the regulations covered by this decision were identical with those contained in the uniform system of accounts adopted by the New York First District Commission in 1908, and as the regulations applied to the case in hand and were the ones criticised by the present applicant company, the Supreme Court decision above quoted seemed to leave no excuse for altering the previous finding of the Commission in this case.

Metropolitan Company, it did not follow that it lacked power to make ordinary amortization requirements.

The general amortization order issued at the time of the reorganization, the Commission held, had been made under a mistaken idea of the Commission's power to limit the amount of capital in a reorganization case as the law then existed, while the amortization requirements insisted upon in the present case as to car-replacements were authorized under the provisions of the Public Service Commissions Law which gave the Commissions power to prescribe a uniform system of accounts applicable to all corporations under its jurisdiction. Naturally, if an exception were to be permitted to a uniform system of accounts, its uniformity would cease to exist.[18]

Another interesting contention of the applicant was that the Commission in making its order as to car-replacements assumed that the New York Railways Company (the applicant) was responsible for depreciation upon the property while it was in the hands of the Metropolitan Company (its predecessor). Of course, no such assumption was involved. The present application involved the replacement of old cars with new cars, and it was, therefore, necessary to ascertain the amount of the actual replacement. As the company's books contained

[18] In the Supreme Court case cited in the footnote preceding, that of the Kansas City Southern Railway Company, the company had urged that if the requirements of the Interstate Commerce Commission's uniform system of accounts were applied to the case then pending, the internal affairs of the corporation would be interfered with, and that an exception should be made in their case. The company contended that the power of prescribing forms of accounts, which was vested in the Interstate Commerce Commission recognized a distinction between the form and the substance. While it granted that the Commission must, in order to obtain full and accurate information about the affairs of a corporation, have power to require any reports or schedules of accounts necessary to show its true financial condition, yet such a grant, in order not to be an unconstitutional delegation of legislative power, must stop short of a point where the regulation in its essence went not to the form but to the substance and involved interference with the internal affairs of the corporation. The Supreme Court in a unanimous decision, referred to above, explicitly recognized the power of the Commission to make accounting regulations which should govern the substance as well as the form of corporate financial operations, as follows:

"We do not, however, think that any such distinction between the form and the substance is admissible with respect to the declared object of standardizing railroad accounts and obtaining therefrom full and accurate information concerning the affairs of the respective corporations. The very object of a system of accounts is to display the pertinent financial operations of the company, and throw light upon its present condition. If they are to truly do this, the form must correspond with the substance."

no detailed distribution of assets (see discussion of same in re Brooklyn Union Gas Co., page 98), which would show the figure at which the old cars were carried in capital account, the Commission must perforce assume that the cars were carried at their original cost, and treat this as the figure at which they were to be replaced.

In the Third Avenue reorganization case the Commission took the position that the new company was purchasing the property of the old and that the capitalization of the new company should not exceed the *value* of the property acquired. The Court of Appeals, however, held that, as the Public Service Commissions Law stood at that time, capitalization need not be limited to value. The Metropolitan reorganization committee had taken advantage of this position to issue securities far in excess of value, and hence their successor, the New York Railways Company, in assuming the benefits of the Third Avenue decision, also assumed its obligations. It could not capitalize without regard to value and then claim all the advantages it might have had if it had capitalized upon a basis of value.

The counsel for the applicant stated that if he were replacing the identical cars, he would still ask to be allowed to capitalize the difference between *value* and *cost*, less possibly the small depreciation accruing since the reorganization. Obviously, the Commission held, if such a position were tenable, obligations for replacements or accrued depreciation for which no provision had been made could be side-stepped simply by going through the form of reorganization. A corporation would then be obliged to provide only for depreciation accruing from the date of reorganization. Such a procedure would result in the injection of "water" into a company's capitalization just as effectively as if it were included in the original securities of a corporation, and the only sound solution for neglected depreciation seemed to be to compel a company to make up such deficit out of earnings as rapidly as possible, even if dividends must be sacrificed in so doing. It certainly cannot be charged to capital account and a technical change in corporate name or form, such as that involved in a reorganization, could not remove the obligation. The result of this proposition was clearly stated in the opinion of the United States Supreme Court in the Knoxville Water case mentioned above. We quote as follows:

If, however, a company fails to perform this plain duty and to exact sufficient returns to keep the investment unimpaired, whether this is the result of unwarranted dividends upon over-issues of securities, or of omission to exact proper prices for the output, the fault is its own.

The principle involved in this case is of vital importance because it would logically follow, and counsel in this case freely admitted it, that if the Commission were to allow the capitalization of the difference between the *value* of the old cars and the *cost* of the new, the same principle would be applied to all other property, whether cars, power stations, substations, tracks, boilers, engines, etc. The company would ask permission to capitalize the difference between *value* and *cost*, with a reduction for accrued depreciation since the date of reorganization.

In the words of the opinion: "the very corporation which was reared upon the ruins of the Metropolitan system now comes before the Commission and asks that we fix the stamp of our approval upon the very practise which caused or aided the disruption of the Metropolitan system."

If replacements must be made up from funds accumulated from income, and this is the accepted rule, then they are operating expense, and therefore, as Commissioner Maltbie held in this case, "the failure to deduct retirements from capital account at the same figure at which they went into capital account is actually the capitalization of operating expenses and will inevitably result in inflation of capitalization."

Dilemma in which a Commission may be Placed in Opposing the Capitalization of Replacements

Both New York State Commissions have bitterly opposed the insidious evil involved in the capitalization of replacements, and their attitude is well stated by former Chairman Stevens in the opinion upon the Niagara case to the following effect:

> Overcapitalization effected by bonding for replacements is as vicious as overcapitalization effected in any other manner. It is overcapitalization which the Commission is to prevent as it would a pestilence. Overcapitalization which has become an accomplished fact, upon which rights are based, which has been tolerated, if not recognized by law, is one thing; overcapitalization by authority and approval of the Commission is another.[19]

A business open to competition would soon succumb to such a course, but one enjoying a monopoly, wholly or in part, (and this applied to most public utilities prior to the Commissions Law) could save itself and its investors through its power over the prices paid by the consumer. The great increase in the number of public service corporations in the last

[19] Matter of Application of Niagara Light, Heat and Power Company, 2 P.S.C.R., 2nd Dist., N. Y., 90. Decided June 29, 1909. See middle of page 112.

twenty-five years and the financial methods pursued in many cases, had brought the public to a realization of an intolerable situation and resulted in the creation of the Commissions and the broad powers given them. The corporations which were now (since the enactment of the Public Service Commissions Law) compelled to resort to the Commissions to raise new capital, were beginning to find that a day of reckoning was at hand.

The Commissions, on the other hand, often found themselves facing delicate and embarrassing situations in thus opposing the capitalization of replacements. Two of the chief functions of a Commission under the Public Service Commissions Law, are the enforcing of adequate service to the consumer, and the regulation of security issues. Frequently cases arose in which inadequate service due to outworn plant could be relieved only by new financing which would involve the capitalization of replacements, due to the fact that the company had made no provision in the way of depreciation reserves. In such cases a strict supervision of the security-issues would deprive the consumer of badly needed service.

The Niagara Case

The Niagara case presented conditions similar to those outlined above, and is also of value because of the financial plan suggested by the Commission in an effort to meet the dilemma. The Niagara Heat, Light and Power Company petitioned for authority to issue bonds to the amount of $50,000.[20] The property had been taken over by the present corporation in 1902 and the claim was made that in the seven years following, the plant had been almost wholly rebuilt at an expenditure of $175,000, of which $61,000 had come from surplus earnings. In the balance sheet submitted by the company, plant and equipment were placed at $651,000. An analysis of this figure showed it to be made up as follows: Franchises—$205,125.35; bond discount $35,000; items properly chargeable to operating expense, $68,533.98 and actual plant and equipment—$343,204.37.

In 1902 actual plant and equipment had stood at $197,819.75. Since that time the gas-making apparatus had been almost wholly reconstructed, and in addition a large amount of old mains had been abandoned and new ones laid in lieu thereof. The Commission's engineer placed the value of the abandoned mains at $55,000. Instead of crediting these mains to capital in the amounts at which they stood in the books, the

[20] See preceding footnote for reference.

full amount remained upon the books, and in addition, the new work, which was replacement pure and simple, had been charged in full, so that the account "Plant and Equipment" stood charged with both the amount of the old work which had gone out of existence and the cost of the new work which replaced it. Any just statement of the affairs of the company would have credited this amount to capital and reduced existing plant and equipment by so much. A revised balance sheet would have changed a claimed surplus of $63,000 to a deficit of $73,000; would reduce plant and equipment from $651,863.70 to $288,204.37, and would show an excess of bonded indebtedness over Plant and Equipment and Unamortized Bond Discount of practically $35,000.

During the seven years since it had taken over the plant, the company had, among other things, issued $100,000 of stock without consideration, making a balancing charge to franchise in the same amount; had removed worn-out parts of its plant to the value of $55,000 and replaced the same without making any credit to capital, but had added the cost of the new equipment; used $27,000 of bond proceeds for operating expense; had carried $37,000 of bond discount as an asset without any attempt to amortize; had carried no depreciation; had charged full cost of gas wells, an asset of limited life, to plant and equipment without any provision for amortization.

One of the items in the application was for $18,600 for renewal of certain gas-pipe, every foot of which was already capitalized and charged to plant and equipment. As plant and equipment had never been credited with any sum whatever for depreciation, the new pipe would be simply a replacement.

The Commission had found difficulty in deciding such cases in a practical way. New service pipe should be laid in the streets, the old mains ought to be replaced, and would have to be if the plant was to render the service to which the public was entitled; and the legal debts of the company must be paid. Yet how could this be accomplished without approving and continuing the vicious financial methods just described, and which would only tend to bring the company into a worse state than before?

The Commission was convinced that, under the circumstances of this case, and under the wide discretion given to it by the law, it had the power to deny this application, and that it should be denied. It also realized that a large number of corporations under its jurisdiction were probably in similar straits, and that it would be unwise to try to lay down

a general rule. It did not decide that it was not wise to do so in the present case, but expressed itself to this effect: "It (the Commission) does not, in view of the universal assent to vicious methods in the past, hold that in every case it will enforce a strict rule regardless of consequences." It was felt that the proper policy would be to endeavor to treat each case upon its individual merits in such a manner as to best conserve the interests of all parties concerned, the public, the security holders and the corporation, with a view to bringing about a gradual change in the financial management of public utilities.

The application, in the form presented, was denied, but a plan was suggested along the following lines; all dividends to be passed until needed replacements had been paid for and present indebtedness for operating expenses liquidated; additional capital to be provided by the stockholders with short time paper, to the payment of which all surplus revenue should be pledged; in addition, the accounts of the corporation were to be recast, fictitious charges eliminated, and stock issued without consideration which still remained in the hands of original recipients was to be surrendered.[21]

The Binghamton Case

The Binghamton case, like the Niagara case, involved a petition for the approval of securities which, if permitted, would have constituted a capitalization of replacements. This case was finally carried to the Court of appeals, and it is of special interest because the decision handed down by this court, while it reversed the specific Order of the Commission, strongly supported its attitude in refusing to sanction the capitalization of replacements. The effect has been to impress pretty thoroughly upon public utility corporations of New York State that capitalization of replacements is untenable, either in theory or in practice.

The Binghamton Light, Heat and Power Company applied for authorization to issue $50,000 of preferred stock and $680,000 of bonds. Of the latter $500,000 were to be used for refunding a like amount of underlying bonds.[22]

The applicant had begun business in 1902, at which time it had taken over the plant of the Binghamton General Electric Company. This plant

[21] For a case involving similar principles see Matter of the Application of the Coney Island and Brooklyn Railroad Co., 2 P.S.C.R., 1st Dist., N. Y., 130. Opinion adopted October 22, 1909.

[22] Matter of Application of Binghamton Light, Heat and Power Company, 2 P.S.C.R., 2nd Dist., N. Y., 171. Decided August 4, 1909.

had been charged to fixed capital in an amount of approximately $500,000. Since that time the applicant had practically rebuilt its physical properties, and the valuation placed by the Commissioner's engineer upon the part remaining was $51,000. With the exception of property worth this amount, it seemed that the plant acquired from the Binghamton General Electric Company had totally gone out of use and disappeared, yet the original amount was still carried upon the books of the company, except for an amount of some $15,000 received from the sale of junk, which had been duly credited to capital. Of $158,000 of outstanding notes which it was desired to refund, it appeared that the greater part had been used in making replacements. These replacements had also been charged to Fixed Capital, so that both the abandoned plant and the replacements thereof appeared as assets. In short, the applicant had followed the usual practice of replacing its worn-out plant with the proceeds of new issues of stocks and bonds and charging to Fixed Capital the cost of the new plant, while at the same time it retained the cost of the destroyed plant in its Fixed Capital account as an asset.

In connection with the application of the Niagara Light, Heat and Power Company the Commission took the position that in the exercise of the wide discretion given it in such matters, it would not, under ordinary circumstances, approve an issue of stocks or bonds for the purpose of making replacements of fixed capital without a readjustment of the accounts of the corporation.

The same principle was adhered to in this case. The Commission had been unable to ascertain the sum at which the old plant was being carried in Fixed Capital account. It suggested that such ascertainment be made, and that the applicant either credit the same to Fixed Capital, or else create a charge upon net income which would accumulate a fund to wipe out the amount. Some such steps would be necessary, it was intimated, as a pre-requisite to the coöperation of the Commission, as additional capitalization would not be permitted upon the basis of the existing untruthful accounts. The case was continued to give the applicant an opportunity to present some plan in conformity with the requirements of the Commission.

A few months later the company again came before the Commission, but was unwilling to make any concessions from its former position. What the Commission especially objected to was the fact that the applicant still sought permission to issue bonds to refund certain notes to the amount of $158,000, the proceeds of which notes the Commission found had been used in great part for making replacements to the plant

of the company to an extent stated to have been "the practical rebuilding of the plant."

The Company had been given an opportunity to prove that such was not the case, but had failed to deny the former finding of the Commission in this respect. It contended that the application should have been granted unconditionally, notwithstanding such finding, as a matter of legal right; that is, the company was entitled to capitalize money expended for replacements, and at the same time, retain in its fixed capital account the value of the property replaced.

To sustain their contention as to their legal right to the proposed issue the applicant relied upon the decision of the Court of Appeals in the Delaware and Hudson case.[23] The Commission held that the principle there laid down was not relevant to the present case, as in that case the matter involved was of indebtedness incurred in the acquisition of property, a proper capital charge, and there had been no question as to false and misleading accounts. The indebtedness was incurred in the purchase of property which the Commission held was disconnected with the railroad properties of the applicant, upon which it was sought to charge the new bond issue, and the application was denied on the ground that it was against public policy, as tending to impair the power of the company to properly perform its functions as a common carrier in the use of its railroad properties.

In this case the Commission held that the indebtedness had been incurred for replacements, and that these are not a capital charge unless the amount at which the replaced property was charged to fixed capital account has been credited at the time of withdrawal. The applicant, however, did not claim that the Commission had overstepped the limits of its discretionary power, as the Court of Appeals had accused it of doing in the Delaware and Hudson case, but went so far as to deny that the Commission, in this case, possessed any discretion.

Finally, representatives of the company suggested a compromise arrangement by which the Commission should approve the issue of $158,000 in bonds for the refunding of the outstanding notes, while the company would agree to reduce its capitalization by $100,000. The Commission agreed to this plan and issued an Order based upon it. A little later, the company, for some unknown reason, appealed from the Order of the Commission, the terms of which it had itself suggested. Hence, it can easily be seen that when the company thus reversed its attitude toward the

[23] People ex rel. The Delaware and Hudson Co. vs. Stevens, 197 N. Y., 1. Decided December 7, 1909.

Order, it left the Commission in the position of requiring the company to immediately cancel $100,000 of its capital stock. Totally aside from the question of whether it had the power, or thought it had the power so to do, there was no such idea in this case, as the Commission had simply agreed to the compromise suggested by the company.

It might have been more expedient for the Commission to have made some arrangement for the gradual amortization of the excess capitalization, as was done by the First District Commission in the case of the Brooklyn Borough Gas Company, discussed under the heading 'Amortization of Excess Capitalization.[24]

At any rate the company saw fit to object to the Order, and instituted proceedings *in certiorari*. The Appellate Division of the Supreme Court, however, supported the Commission, and an appeal was taken to the Court of Appeals. In a unanimous opinion, that Court held that, under Section 69 of the Public Service Commissions Law, even before the amendment of 1910, the Commission had no power to approve the issuance of securities for the discharge or refunding of indebtedness incurred for renewals, or for the payment of operating or other charges which ought to be paid out of income.[25] According to this decision it was incumbent upon the Commission, before approving an issue of bonds for the discharge or refunding of obligations to apply three tests, as follows:

(1) To ascertain the purposes for which the expenditures were made.

(2) To determine whether all represented permanent improvements of the plant or renewals and replacements of obsolete or worn-out property.

(3) To segregate all expenditures for maintenance, renewals, and replacements, and to permit the capitalization of only such expenditures as represent permanent improvements.

The Court of Appeals strongly supported the power of the Commissions, under the Public Service Commissions Law as originally drafted, to prevent the capitalization of replacements. This discussion, however, was, to some extent, in the nature of obiter dicta.

The Court of Appeals assumed that the Commission had sought to compel the company to reduce its capital-stock by $100,000, and it reversed the decision of the Appellate Division of the Supreme Court upon the point at issue, holding that "the condition imposed by the Commission (the cancellation of $100,000 of capital stock) unless perhaps

[24] See page 98.

[25] People ex rel. Binghamton Light, Heat and Power Company v. Stevens, 203 N. Y., 7. Decided October 3, 1911.

to adjust the financial affairs of the corporation with the consent of the stockholders or stockholders and bondholders was wholly unauthorized."[26]

New York Commissions Cannot Compel Provision for Depreciation

The power of the Commissions to compel the setting aside of funds for depreciation reserve has been a question since the enactment of the Public Service Commissions Law. In view of the decision handed down by the Court of Appeals in May 1918, this point has been definitely settled in the negative.[27] The only course now open is an amendment to the Law.

Sections 52, 66, 80 and 95 of the Public Service Commissions Law authorize the Commissions to prescribe uniform methods of keeping accounts, records and books to be observed by the different classes of utility corporations. During 1908, each of the Commissions prepared systems of uniform accounts which became effective on and after January

[26] Pertinent excerpts from the dicta of the court in this case are quoted as follows: "The question as to what expenditures are a proper basis for permanent capitalization is an important one, always a proper and necessary subject for consideration, not alone by the directors of a corporation, but by any commission that has authority to grant or withhold its consent to the issue of new stock or bonds which are to become a part of the corporation's permanent capitalization. . . .

"It will not be denied that fuel and such other materials as are consumed from day to day and the labor incurred in daily maintenance should be paid for from the earnings of the corporation as a part of its running expenses prior to the payment of interest upon bonds or dividends upon capital stock. A reasonable consideration of the interests of a corporation and the ultimate good of its stock and bondholders and a regard for the investing public and that fair dealing which should be observed in all business transactions, requires that machines and tools paid for and charged to capital account but which necessarily become obsolete or wholly worn out within a period of years after the same are purchased or installed, should be renewed or replaced by setting aside from time to time an adequate amount in the nature of a sinking fund or that by some other system of financing the corporation put upon the purchaser from the corporation the expense not alone of the daily maintenance of the plant but a just proportion of the expense of renewing and replacing that part of the plant which although not daily consumed must necessarily be practically consumed within a given time. If that is not done and renewals and replacements are continually added to the capital account the capital account must necessarily become more and more out of proportion to the real value of the property of the corporation."

For similar cases involving capitalization of replacements see the Matter of Application of the New York Municipal Railway Corporation, 4 P.S.C.R., 1st Dist., N. Y. 105, Orders entered March 20, 1913, and also the Matter of the Application of the Belt Line Railway Corporation, 4 P.S.C.R., 1st Dist., N. Y. 411. Opinion adopted November 7, 1913.

[27] People ex rel New York Railways Co., et al., Public Service Commission 223 N. Y., 373. Decided May 14, 1918.

1, 1909. These systems included railroads, gas companies, and electrical corporations. Subsequently similar systems were adopted for telegraph and telelphone companies and for steam heating companies as they were brought within the jurisdiction of the commissions.

The requirements of the uniform systems of accounts have the force of law.[28] The orders of the Commissions relative to the uniform systems of accounts require that when fixed capital is retired from service, depreciation applicable to the period after December 31, 1908, is to be charged to the depreciation reserve.

The Fixed Capital Account is to be divided into capital acquired prior to December 31, 1908, and capital acquired subsequent to that date. The object of this requirement was to keep the 'watered capitalization' existing on December 31, 1908, (where any such did exist), in a separate compartment, and thus make it easier to keep track of it than would be the case if subsequent additions to capitalization were lumped in with the old. In other words, to segregate the existing excess capitalization as far as possible, to keep it segregated, and to compel the observance of correct principles of accounting with regard to changes in capitalization subsequent to the taking effect of the Uniform Systems of Accounts.

This compulsory division of capital account into two parts, that existing prior to December 31, 1908, and that created subsequent to such date, was in itself a great reform over existing conditions.

The provision of the uniform system of accounts further stipulates with regard to the setting aside of reserves for depreciation, that until otherwise ordered, the amount estimated to be necessary to cover such depreciation month by month is to be based upon a rule to be determined by the company, which rule may be amended. It would be necessary to leave the rule open to amendment, as subsequent developments might be very likely to show that the rate has been set too low or unnecessarily high to accomplish its purpose. The question is, who has the real power to do the amending, the corporation or the Commissions? Some light was thrown upon this point by the decision of the Appellate Division of the Supreme Court for the First Department, in connection with a ruling of the first District Commission upon an application for approval of an issue of securities brought by the Kings County Lighting Company.[29]

[28] People ex rel. Bridge Operating Co. vs. Public Service Commission 153—App. Div. N. Y., 129. Decided November 15, 1912. See page 137.

[29] People ex rel. Kings County Lighting Company, 178 App. Div. 840. Decided July 13, 1917.

On September 10, 1915, the Kings County Lighting Company had requested the approval of the First District Commission for the issuance of $675,000, 5 per cent bonds. Of the proceeds, the sum of $135,000 was to be applied to the reimbursement of moneys expended from income prior to July 1, 1915, for additions and betterments.

On May 25, 1916, the Commission entered an Order authorizing the applicant to issue $472,000 of the proposed bonds. Later, however, on September 8, 1916, pursuant to a rehearing granted by the Commission to the company, the previous Order was amended so as to permit the issue of bonds for the full amount of $675,000 originally asked for.

The Order stipulated, with regard to the amount asked for reimbursement of the treasury, that the sum of $134,545, should be applied only (to quote):

> For reimbursement of moneys expended from income or such other moneys in the Treasury for the construction, completion, extension or improvement of its facilities, plant or distributing system and when so reimbursed to be used only to make good depreciation in the property of the company.

The Company refused to accept the terms of the Commission's Order. It objected to the requirement that the sum of $134,545 allowed for reimbursement, "be used only to make good depreciation in the property of the company," and sued out a writ of certiorari to review the determination of the Commission. This was granted, and the case was heard on June 6, 1917.

It appeared from the evidence that only a minor part of the sum stated had been derived from the depreciation account, the remainder being from income. The effect of the Commission's Order would be to turn all this income into the company's depreciation account. This the company claimed the Commission had no authority to do.

The company, in compliance with the requirements of the Uniform system of Accounts instituted by the Commission, and which had become effective January 1, 1909, had filed a rule providing for the retention of eight cents per thousand cubic feet of gas sold, for a depreciation fund. From January 1, 1909, to July 1, 1916, it had made charges to operating expenses and credits to accrued amortization of capital upon that basis. In August 1916, the company had filed an amended rule from July 1, 1916, providing for a charge of 11½ cents per thousand cubic feet of gas sold to the account of "General Amortization—Gas." The company did not set aside any separate fund for depreciation reserve, but took care of it in its bookkeeping by means of deductions from fixed capital. Hence, a part of the funds expended "from income or

from other moneys" in the treasury of the relator represented depreciation. An analysis of the company's balance-sheets showed that, under the 8 per cent rate, the portion of the money so spent amounted to $48,000. To permit the company to issue bonds to reimburse it for this amount would be to permit it to capitalize its depreciation fund, a practice which would lead to bankruptcy. The Commission, the court held, would have been compelled to deny an application to issue bonds to reimburse the Treasury for money spent out of the depreciation fund "whereas it would have been not only justified but required to issue its consent if such had not been the fact."

The Order of the Commission, however, the court held, undertook to require the company to apply a much larger sum than the depreciation fund under the 8 cent rate had amounted to. This the Commission arrived at by applying the 11½ cent rate since 1909.

In concluding its opinion the court held as follows:

there was no legal justification for the Commission so doing. The Company was entitled under the law to fix its own rule or rate of depreciation, and it fixed the same at eight cents. In no event could the Commission, without taking an independent proceeding against the relator, in which the relator would have notice and an opportunity to defend itself, make an order requiring it to change its whole system of accounting and put its depreciation charge upon some other basis than that adopted by the company under the law, and the earlier order of the Commission.

The Court therefore modified the order of the Commission by providing that out of the $134,545 allowed for reimbursement of moneys expended from income the sum of $48,000 only should be used to make good the amount spent out of depreciation reserve.

The court, in short, took the ground that because the company had filed a rate of eight cents per thousand cubic feet of gas sold to be retained for depreciation reserve, and the Commission had made no objection, that therefore, the Commission virtually approved such rate.

As every gas company under the jurisdiction of the respective Commissions has different conditions making for depreciation, and, consequently a different rate of depreciation, the Commission would have to make an investigation in the case of each company filing a rate. The work involved, especially in the case of the several hundred small companies under the jurisdiction of the Second District Commission, makes such a proposition absurd. The attitude assumed by the court in this decision would seem to uphold the position that, upon the filing of a rate for depreciation by a company, the absence of protest at that time by the Commission amounts to virtual acceptance of such rate of depreciation

by the Commission and ties its hands in that regard if it later has occasion to consider the adequacy of the rate. If one rate is investigated at the time of filing, then all would have to be so examined. Such a task would be well-nigh impossible.

The practical effect of this decision was to cast grave doubt upon the powers of the Commission in the matter of requiring the setting aside of reserves for depreciation.

The next judicial interpretation bearing upon the Commissions' powers over depreciation was a decision by the Appellate Division of the Supreme Court for the First Department in connection with the depreciation requirement which the First District Commission had imposed upon the New York Railways Company.[30] The latter had been reorganized in 1912, upon the wreck of the Metropolitan system during the period between the Third Avenue decision of the Court of Appeals and the adoption of the reorganization amendment, and during which time the Commissions were compelled to approve reorganization plans coming within the terms of the old reorganization law, no matter how much the amount of new capitalization seemed to exceed the value of the property.

The Commission in this instance had felt constrained to adopt a plan far in excess of the property value and in order to carry out this plan, had finally made three orders (1) on January 24, 1912, authorizing the issue of the stocks and bonds; (2) on February 27, 1912, consenting to the execution of the mortgages (3) on February 27th, 1912, providing among other things as follows:[31]

Section 3. Ordered, that the New York Railways Company before declaring or paying any dividend on its shares of stock or interest on its bonds secured by said adjustment mortgage shall expend or set aside each month beginning January 1, 1912, for maintenance and depreciation during such month a sum at least equal to twenty per cent of its gross operating revenue for such month, and if this amount is not expended for repairs and maintenance within that month the unexpended portion thereof shall be credited as of the end of that month to the account (Accrued Amortization of Capital) in accordance with the provisions of the uniform system of accounts prescribed by this Commission, for street and electric railways.

A subsequent order of December 10, 1912, amended this order in certain particulars but left the depreciation reserve provisions un-

[30] People ex rel New York Railways Co., et al vs. the Public Service Commission, 181 App. Div., 338. Decided January 18, 1918.

[31] Matter of Plan for Reorganization of the Metropolitan Street Railway Company, 3 P.S.C.R., 1st Dist., N. Y., 113. (See bottom page 125.) Opinion adopted February 27, 1912.

changed.[32] Under date of December 21, 1914, the New York Railways Company requested an amendment of the Order of December 10, 1912, "so as to provide that the amount required to be expended or set aside each month for maintenance and depreciation shall be a sum at least equal to 20% of the gross passenger revenue for each such month instead of, as in said Order provided, 20% of the gross operating revenue, and that said order may be so amended nunc pro tunc as of January 1, 1912."

. . . This application was denied August 4, 1914.[33] In the meantime the Company sued out a writ of certiorari to review the Commissions' Order. The matter was argued at the Appellate Division of the Supreme Court for the First Department on December 12, 1917. On January 18, 1918, the latter handed down a decision sustaining the action of the Commission in requiring the New York Railways Company to set aside monthly 20 per cent of its gross revenue into a depreciation fund [34]

The Court in its opinion stated that the original order of the Commission in this regard had been made upon abundant proof as to the reserve fund necessary for maintenance and depreciation. The company, it appeared, did not question the order upon that ground, but based its case upon the contention that, right or wrong, it was the province of the corporation directors and not that of the Commission to determine what amount should be set aside for that purpose.

The Court pointed out that, since February, 1912, the date of the original order, 20 per cent had been set aside as required; of this 20 per cent the company's records showed that 16⅔ per cent had been required for actual maintenance expenses, leaving 3⅓ per cent which had been set aside to provide for depreciation and obsolescence. At the time the case was considered by the Court (January 1918) a fund of $3,000,000 had thus been accumulated, while the company had been able to pay only 3 per cent upon its income bonds instead of 5 per cent. The reorganization plan provided that these income bondholders were entitled for a time to name directors to a number one less than a majority of the board and it was further pointed out that if the amount of this fund to be reserved for depreciation were to be left to the directors it was fair to assume that, with so large a representation of the income bondholders

[32] Matter of Application of the New York Railways Company, 3 P.S.C.R., 1st Dist., N. Y., 453. Opinion adopted December 10, 1912.

[33] See also Matter of Rehearing upon the Application of the New York Railways Company, 6 P.S.C.R., 1st Dist., N. Y., 237. Opinion adopted July 27, 1915.

[34] People ex rel. New York Railways Company Public Service Commission, 181. App. Div. N. Y., 338. Decided January 18, 1918.

upon the board, the moneys thus reserved would largely be applied to the payment of the interest upon these bonds up to 5 per cent, and the fund reserved for depreciation would be reduced to a minimum, although the amount now reserved was shown by the evidence to be no more than was necessary to take care of depreciation and obsolescence. If the company's contention was sound, the Court held, the directors could entirely deplete this fund for the payment of this interest until there came a time when such a fund would be necessary to restore the road to a proper standard and there would be no fund applicable thereto and the commission charged with the duty of protecting the public would be powerless to prevent the waste.

The court then quoted at length from the opinion of the Court of Appeals in the Binghamton case to show (1) that the allowance for depreciation and obsolescence must be deemed a part of the operating expenses of a corporation and (2), that a corporation is not authorized to issue bonds or stock to provide therefor and that the Public Service Commission is not authorized to consent to such an issuance.[35] The court pointed out that, while the capitalization of replacements was not the issue in this case, there was squarely presented the converse of that proposition, namely, proper and necessary provision against the need for such a course. If, as laid down in the Binghamton case, the court held, new stock or bonds cannot issue to make good depreciation and obsolescence, and if, as contended by the company, the Commission is not authorized to require a sufficient fund to be set apart to provide for the same "the legislature has wholly failed to accomplish its purpose to provide protection for the investing and traveling public. That this was the purpose of the creation of the Public Service Commission is held by all the authorities." For not only was the issuance of new stock and bonds made subject to the approval of the Commission, but explicit power was given to the Commission to provide complete and adequate equipment for the convenience of the traveling public, to order repairs, changes, alterations in terminal facilities, motive power and equipment, in order to provide what in its judgment was "adequate service and facilities for the transportation of persons and property.[36]

The Court further pointed out that while under the settled rules of statutory interpretation power was 'impliedly' given to take such action

[35] People ex rel. Binghamton Light, Heat and Power Company v. Stevens, 203 N. Y., 7. Decided October 3, 1911.

[36] See Public Service Commissions Law, Section 50. (Chapter 480, Laws of 1910, or Consolidated Laws, Chapter 48).

as might be necessary to make effective the powers explicitly given to accomplish the purpose of the enactment, in this case resort to the rule of 'implied powers' was not necessary, as it was provided that "There shall be a Public Service Commission for each district and each Commission shall possess the powers and duties hereinafter specified and *also all powers necessary or proper to enable it to carry out the purposes of this act.*[37] That if the Commission did not possess this power the directors would be at liberty to divert to the payment of the interest on the income bonds this depreciation fund which is necessary for the maintenance of the value of the security and also necessary for adequate service to the traveling public. When, in time, it became necessary to replace obsolescent and depreciated equipment no fund would have been created for that purpose. As the Commission would have no authority to assent to the issuance of new securities for that purpose, it would be impossible for the company to make the necessary replacement because of lack of funds and the ability to procure them. The corporation would become unable to perform its public functions, bankruptcy would ensue and another reorganization, with the attendant impairment of securities, would become necessary.

"The Court" it was held, in conclusion, "should not so construe the powers given as to permit the very evils which the Legislature has sought to remedy. This holding now made does not substitute the judgment of the Commission for that of the Board of Directors except so far as may be absolutely necessary to provide for the maintenance of the value of the securities and of adequate facilities for transportation by the requirement to pay what is deemed in law 'Operating expenses' from income and as I[38] read the statute in view of the purposes of its enactment this authority is there given."

This was probably the most liberal opinion ever handed down by the New York Courts in connection with the Public Service Commissions and seemed to leave no doubt as to their power to compel the setting aside of adequate depreciation reserves.

The Company appealed to the Court of Appeals and four months later (May 1918), there was handed down a decision which reversed the decision of the Appellate Division and which seems to settle definitely

[37] Italics not in original.

[38] Public Service Commissions Law, Section 4.

that the Commissions do not have power to compel provision for depreciation.[39]

If the premise assumed by the decision of the Appellate Division is true, that the purpose of the creation of the Commissions was to provide protection for the investing and traveling public, then certainly under the decision of the Court of Appeals, they cannot achieve the purposes of their creation. Apparently, the power to amend the depreciation rate rests with the company and it alone, and if the companies do not see fit to set aside adequate depreciation, there will ultimately be urgent calls for securities to finance replacements. As such a procedure will be illegal, reorganizations with their attendant consequences to security holders will be inevitable. The difference between the two opinions is simply that between broad and narrow construction. The Court of Appeals says that the sole question is whether the Commissions have power to make the order and that the Commission bases its claim upon Section 52 of the Public Service Commission's law, relating to the Commission's powers to prescribe uniform systems of accounts. This section, the Court claims, gives power "not to regulate the management of their finances but to show what the management was." The decision states further that the other sections of the act to which reference has been made clearly "*do not in express terms*[40] authorize the Commission to require the creation of a reserve fund to renew the plants when the same shall be worn out or shall become obsolete. It is not pretended by anybody that they do."

This is perfectly true. Such authority does not exist in express terms and the appellate Division did not claim so. "The power of the Public Service Commission is extensive," the Court of Appeals admits, "and should be construed in the same spirit, but when a particular power is exercised by the Commission or is claimed for it, that power should *have its basis in the language of the state or should be necessarily implied therefrom.*"[41] Thus, the Appelate Division takes as a basis its conception of the general purpose of the statute, while the Court of Appeals takes as its basis the language of the statute. Reference is made to

[39] The majority opinion of the Court in this case was written by Justice J. Smith. A dissenting opinion was filed by Justice J. Scott. See People ex rel. New York Railways Company vs. Public Service Commission. 181 App. Div. N. Y., 338. Decided Jan. 18, 1918.

[40] Italics not in original.

[41] Italics, not in text of opinion.

Matter of Quimby vs. Public Service Commission[42] in which the same court had held that the legislature had not delegated to the Public Service Commission the power to increase the rates of fare that may be charged by street surface railroads in the city of Rochester, "on the ground that we found *no word*[43] in the statute which disclosed a legislative intent to delegate such power to the Commission."

The Rochester case was held to be controlling in the New York Railways case.

[42] Quimby et al. vs. Public Service Commission 223 N. Y., 244. Decided April 5, 1918.

[43] Italics not in original.

CHAPTER XII

Miscellaneous Considerations

In a number of the earlier cases, especially in the Second District, the leading issue was really an interpretation of the Public Service Commissions Law upon the points involved. While these cases may not be vital, they are of interest, and are necessary to an understanding of the development of Commission control of capitalization in New York State.

Securities Cannot be Issued to Create Surplus or Reserve Funds

An interesting question came up in connection with the application of the Bronx Gas and Electric Company,[1] previously discussed.

Among the purposes mentioned in the application for which the proposed security proceeds were to be applied, it was stated:

> that it is necessary in the operation of your petitioner's business to keep and maintain a proper surplus fund and a proper reserve fund to meet various contingencies including the repayment of deposits made by customers, and it is the purpose of your petitioner to apply an appropriate proportion of said loan to the re-establishment of said funds.[2]

The Commission held that the Public Service Commissions Law gave it no authority to approve an issue of bonds to be used to create surplus or reserve funds. A further portion of bonds proceeds were to be used to refund an item of approximately $24,000 of taxes. It was also held that the objections to the capitalization of taxes, which were properly an operating expense, were obvious, and such capitalization would not be permitted even under unusual circumstances.

Issue of Stock for the Purpose of a Stock Dividend Not Legal

Several of the earlier cases brought up the matter of stock dividends in one form or another. The Babylon Electric Light Company applied[3] for permission to issue additional capital stock to the extent of $60,000. Of this amount $30,000 was to be used for extensions and improvements to its plant. An investigation showed that such an issue was justified, but a stipulation was added that some proof should be given as to the

[1] Matter of Application of the Bronx Gas and Electric Company, 2 P.S.C.R., 1st Dist., N. Y., 150. Opinion adopted November 12, 1909.

[2] See *supra*, bottom page 154.

[3] Matter of Application of Babylon Electric Light Company, 1 P.S.C.R., 2nd Dist., N. Y., 132. Decided March 9, 1908.

price for which the stock would be issued. Of course, the stock of a public utility in New York state cannot be issued for less than par, and this requirement of the Commission referred to the premium which might (or might not) be obtained. The amount of the premium should be accounted for and should serve to cut down the amount of stock which would need to be issued.

The remaining $30,000 was to be issued as a stock dividend. The outstanding capital stock amounted to $15,000, divided into three hundred shares of $50 each. The petition spoke of raising the present three hundred shares to nine hundred shares, to be perfected by giving each present stockholder two additional shares of stock for each one that he then held.

Examination showed that the assets were worth practically $30,000 above any indebtedness or present capitalization, and that during a number of years surplus net earnings had been devoted to extensions and improvements.

It was not and could not be claimed that the issue of a stock dividend was for any of the four purposes enumerated in the Public Service Commissions Law. No capital would be procured by such an issue, and hence the amount to be secured by it, that is, nothing, could not be reasonably required for any of the purposes mentioned. Therefore, it was held that the issue of a stock dividend by corporations subject to the jurisdiction of a Public Service Commission was not legal.[4]

[4] In this connection an interesting discovery of a stock dividend embedded in the existing capitalization of a company was furnished in the course of the proceedings upon the above application of the Bronx Gas & Electric Company. The outstanding securities and the purposes for which the proceeds were expended were investigated. As a result, the Commission was convinced that a certain issue of stock in 1905 was practically a stock dividend. In May 1905, 2,160 shares of stock (par value $216,000) were issued for "property and services" according to the entries in the stock certificate book. At the same time the debit balance in plant account had been increased by $216,000 without a single entry to show what the sum represented. An examination of the books and records of the company showed that each stockholder had received eighty per cent of his holdings in new stock, the issue thus constituting a stock dividend. The equality of distribution was carried to such an extent that certain stockholders were given eight-tenths of a share and certain others two-tenths of a share.

The company claimed that this stock was issued to "James Hennessey & Co. (the original construction company) his assignees and transferees;" that it was issued for "property and services," that it was part payment for the plant provided by the construction company at the very beginning, and that the holders of the stock issued in 1905 had a claim through Hennessey & Company as a part of the stock they acquired to further stock from the Bronx Gas & Electric Company.

Scrip Dividends Illegal Under the Public Service Commission Law

An application was presented by the Erie Railroad Company to the Second District Commission for authority to issue its interest-bearing warrants evidencing the right of its stockholders to dividends on its first and second preferred stock.[5] The Board of Directors on August 28, 1907, had declared a dividend of 2 per cent upon its first preferred stock, payable October 1, 1917, and a dividend of 4 per cent upon its second preferred stock, payable November 1st, 1917. It further determined to issue interest-bearing-dividend warrants evidencing the right of the stockholders to dividends so declared, subject to the approval of the Public Service Commission.

The petition filed with the Commission in connection therewith contained the statement that "it is inexpedient and incompatible with the best interests of the company and its stockholders that the dividends in said resolutions referred to, be paid presently in cash, or otherwise than by the issue of interest-bearing dividend-warrants."

The question immediately suggested itself whether in view of the provisions of Section 55 of the Public Service Commission's law, it was within the power of the company to declare a dividend payable more

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The facts were that the said construction company had been out of existence for some time prior to 1905, and that not a single share of the 2,160 had been delivered to it. Further, the applicant could not produce any document showing an order or assignment from Hennessy & Co. directing that stock due it be distributed pro rata to the then stockholders.

The records showed that not one dollar was paid to the Bronx Company for the stock, and no voucher was rendered for any expenditure, that no acknowledgement of the payment of any obligation was given to the company, and that nothing went into the property from the issue of the stock, nor was there anything to show that the stockholders rendered any services or transferred any property to the Bronx Company or to Hennessey & Company which would legally entitle them to the stock they received. The conclusion drawn by the Commission was that "the whole procedure has all the earmarks of a stock dividend, issued because earnings were becoming too large and because there was a balance in the depreciation fund of $185,000, and a surplus of $30,000.

The Commission felt that if the stock issue of 1905 had been sold for cash, the Company would probably not now need to apply for a bond issue, and that it was a grave question as to whether this 1905 stock had not been issued illegally in view of the provisions of the stock corporations law which provides that all stock issued shall be for value received.

[5] Matter of Petition of Erie Railroad Company for authority to issue scrip dividends, 1 P.S.C.R., 2nd Dist., N. Y., 115. Decided February 27, 1908.

than one year after its declaration and to issue interest-bearing warrants evidencing the same, and also the further question whether if the company possessed such power the assent of this Commission to its exercise was necessary under the provisions of Section 55 of the Public Service Commissions Law.

This section read as follows:

A railroad corporation organized or existing under or by virtue of the laws of the State of New York, may issue stocks, bonds, notes or other evidences of indebtedness, payable at periods of more than twelve months after the date thereof, when *necessary* for

the acquisition of property,

the construction, completion, extension or improvement of its facilities,

the improvement or maintenance of its service, or

the discharge or lawful refunding of its obligations, *provided, and not otherwise*, that there shall have been secured from the proper commission an order authorizing such issue and the *amount* thereof, and stating that, in the opinion of the commission the *use* of the capital to be secured by the issue of such stocks, bonds, notes or other evidences of indebtedness *is reasonably required* for the said purposes of the corporation.[6]

The interest bearing warrants mentioned in the application were evidences of indebtedness, and they were payable more than one year after date, hence they came under the category of Section 55, according to which evidences of indebtedness may be issued only when necessary for one of the four purposes named therein. And, in addition, the Commission must be able to say truthfully that the use of the capital to be secured is reasonably necessary for such purposes.

In the making of an Order authorizing an issue of securities, three elements seemed to the Commission to be essential, as follows:

That capital is to be secured by the issue;

That the issue of such stock, bonds, or other evidences of indebtedness is necessary to obtain such capital for one or more of the four purposes enumerated;

That the amount authorized is reasonably required for one or more of such purposes.

A scrip dividend, the Commission held, was not even a dividing of the surplus of a corporation, but merely a promise to pay at some future time. By the declaration of a scrip dividend the company secured nothing which it did not possess before. For a dividend is a parting with capital, a dividing of property among stockholders, and is the direct opposite of the securing of capital. Warrants evidencing a scrip dividend, therefore, secure no capital. Furthermore, such an

[6] Chapter 480, Laws of 1910. Italics not in original.

issue could not be considered reasonably necessary for one or more of the purposes enumerated, because after their issue the directors would have no more power to use the surplus involved than they had before and nothing would then be possible which would not have been possible before.

It might be thought, the Commission argued, that a scrip dividend was a loan from the stockholders of the amount of their dividend, upon which interest is paid. But a scrip dividend is not a loan. A loan would be a receiving of something from the stockholders with their consent, but this was not the case here. This was simply a promise to pay something in the future, but nothing was received from the stockholders and nothing was taken from the company. Such a promise was clearly not necessary for any purpose.

The issuing of these evidences of indebtedness would not have been necessary for the acquisition of property, the construction, completion, extension or improvement of the facilities of the company, or for the improvement or maintenance of the service, for the simple reason that every dollar of the surplus was already available, at the discretion of the directors, for these purposes. There remained only the discharge or lawful refunding of obligations. This would imply the pre-existence of an obligation to be discharged and not the creation of one, but these warrants would represent the creation of an obligation by the directors at the time of their issuance and could not from any point of view represent the acquiring by the company of any value or property which it did not previously possess. The petition was denied upon the ground that the issue of the securities was not for any of the purposes enumerated in the Public Service Commissions Law.

There remained the question as to whether the company could issue such warrants without the consent of the Commission. It was held by the Commission that as the Law enumerated certain purposes for which securities running for a longer period than one year could be issued, and as in common law the mention of one thing implies the exclusion of others, such warrants could not issue without its permission.

Security Issues for the "Reimbursement of the Treasury" of a Corporation Illegal under the Original Act.

The Lehigh and Hudson River Railway Company in applying for consent to the issue of bonds in the sum of $300,000 stated the purposes for which it intended to use the bonds in the following language:

and the purposes for which said bonds are to be used are to reimburse your petitioner in part for the amounts paid by it for and on account of the construction, purchase and acquisition of said Orange County Railroad as aforesaid.[7]

The applicant had advanced large sums for the construction of the property of the latter company, a part of which had been repaid in capital stock of the Orange Company. This still left indebtedness to the applicant of $320,000, to cancel which it had sold to the applicant its entire line of road by means of a merger just prior to the taking effect of the Public Service Commissions Law. Hence, applicant had been fully paid for the money advanced by the transfer of the road. The transaction was ended, and, in the opinion of the Commission, the corporation was seeking permission to borrow $300,000 to reimburse itself for money loaned to another company, which money had been wholly paid by the transfer of the property of the other company.

The applicant company seemed to have no clear idea as to the theory upon which the bonds were to be issued. In another place in the original petition, it stated:

The said bonds are to be retained in the Treasury of the said Railway Company, and are only to be disposed of as the conditions may from time to time require in the construction of additional sidings, double tracking the main line of said railway, constructing new shops and engine houses, and for the purchase of new equipment.[8]

Because of the lack of definiteness as to the purpose for which the money was to be used, a second hearing was ordered. The applicant then presented satisfactory evidence of the existence of promissory notes executed by it to the amount of $162,000, and of a proposed installation of equipment of an amount which brought the total to $270,000, to be used for purposes clearly within the terms of Section 55.

However, there was still no proof offered as to the proposed use of the remaining $30,000, and the application was denied to this extent because of such lack of proof.

It was thought by many that a Commission, under Section 55, might permit a corporation to issue bonds to reimburse itself for money which it had previously taken from its treasury and expended for lawful purposes. The Commission was convinced from a careful examination of the language of the section that money secured from the sale of securities must be used for specific purposes, and only in amounts reasonably required for those purposes. The Commission held as follows:

[7] Matter of Petition of Lehigh and Hudson River Railway Company, 1 P.S.C.R., 2nd Dist., N. Y., 224. Decided May 7, 1908.

[8] See 1 P.S.C.R., 2nd Dist., N. Y., Middle of page 227

Money to be acquired from the sale of stocks, bonds, or other evidence of indebtedness, payable at a period of more than twelve months after the date thereof, is money secured by capitalization, and the spirit of the act (Public Service Commissions Law) is to control capitalization; to see that it is made only for certain legitimate purposes, and then only to an amount that is necessary for the reasonable accomplishment of such purposes.[9]

There were many corporations who had upon their properties general mortgages, under the terms of which, and in the manner therein specified, they could go ahead and improve the mortgaged property with moneys taken from their treasuries, and then, when such improvements had been made, they could apply to the trustee of the mortgage for an issue of bonds to reimburse their treasury by showing to the satisfaction of said trustee that the amount of bonds applied for had been expended upon the property. Under such an issue of bonds, the proceeds could be used by the corporation for any purpose, even the declaration of dividends.

It was felt that under the interpretation of Section 55 as given above, such issues of bonds would be rendered impossible and much confusion caused in a large number of securities. The fact was that the corporation could still go to its mortgage trustee, and, upon proof of additional investment in the property, receive its bonds. That is, it could get them, as far as the trustee, representing the mortgagee, was concerned. But the corporation now (since the enactment of the Public Service Commissions Law) had an additional step to take. It must also obtain the approval of the proper Commission, and the Commission, to grant such approval, must be convinced that the capital involved was to be used for one or more of the purposes enumerated in the statute.

The Commission, in discussing this matter, expressed the opinion that the anticipated difficulties were more imaginary than real. The freedom of the corporation in getting bonds from its mortgage trustee, the Commission held, was certainly curtailed in that the proposed use to which the proceeds were to be put must be stated and must conform to the purpose allowed in the act. But, on the other hand, it was pointed out, the latitude actually resulting under these four purposes was so wide, that practically the only other purpose for which a corporation could wish to use the money would be to declare dividends.

The present case (Lehigh and Hudson River Railway case) was held to be an instance in point. The applicant corporation had made its original petitition upon the basis of reimbursement of the Treasury, but when this was not recognized, the company was immediately able to

[9] See 1 P.S.C.R., 2nd Dist., N. Y., Middle page 229.

make a case entitling it, in conformity with the requirements of the statute mentioned above, to an issue of $270,000 out of a total of $300,000 originally requested.[10]

Expenditures for Other Than Capital Purposes Should be Met from Earnings

A similar case involving reimbursement of the Treasury occurred in the Matter of the Application of the Bronx Gas & Electric Company

[10] This view had apparently been followed by the Second District Commission in framing its Rule of Procedure No. 25, which read as follows:

"Applications under Section 55, for authorization, etc. continued—The order granting an application, or any part thereof, under Section 55, shall contain the following provisions:

1. "Prescribing the purposes for which the proceeds of the security or obligation authorized shall be used.

2. "Directing the applicant to report under oath the sale or sales of the obligations authorized, the terms and conditions of such sale, and the amount realized therefrom.

3. "That the applicant shall make a verified report at least once every six months showing in detail the use and application by it of the moneys so realized, until such moneys shall have been fully expended.

4. "Such other provisions as the Commission may deem necessary or appropriate in each case.

As the Commission pointed out, if bonds could be issued and sold for the purpose simply of "Reimbursement of the Treasury" paragraph 1 of the rule would have no application; in the same way Paragraph 3 would be meaningless, as its whole purpose was to make certain that the money derived from the security issues should be applied to the specific purposes for which they had been approved in conformity with the purposes enumerated in the Public Service Commission Act.

See also Matter of Application of the New York Edison Company, 5 P.S.C.R., 1st Dist., N. Y., 132. Opinions filed March 3, 1914. This application for approval of the issue of stock was based upon a reimbursement of notes issued by the applicant to the Consolidated Gas Company for funds advanced by the latter. Commissioner Maltbie, in his opinion, criticised the lack of definiteness as follows: . . . "Up to this time the company's officials have professed their inability to determine the precise use made of the moneys thus advanced by the controlling company. In their last annual report to the Commission they have not returned any of the amount under the caption, 'Due Associated companies for Construction Advanced.' On the contrary, they stated that 'the money was not borrowed for any specific purpose but was deposited in general cash fund and used to liquidate current debts. It is impossible to identify it with any particular class of expenditure.' It scarcely needs to be said that this loose method of accounting for funds advanced by one company to another does not furnish a satisfactory basis for a balance sheet or for an application to a public authority for approval of new security issues. Money should be appropriated for specific purposes and duly accounted for in accordance with the official declaration of purpose. The separation of working advances from construction advances is carefully made on the balance sheets prescribed by the Interstate Commerce Commission as well as this Commission, and is necessary for the prompt disposition of cases like the the present."

for approval of an issue of bonds.[11] It appeared that a portion of the proposed issue was to reimburse the Treasury for $31,000 of notes that had been paid off some time before. The Commission held that it could not and should not approve the issuance of bonds to pay off notes that had already been paid, as the money could not be used for the purpose stated. As to $35,000 of notes still outstanding and which it was desired to pay off with a part of the proceeds of the proposed issue, no convincing evidence was presented to show that the debt had been incurred for capital purposes. The Commission held that "when a company is unable to prove that an expenditure was made for a capital purpose, the safe and prudent course should be pursued of requiring the company to pay it out of earnings."[12]

Reimbursements of the Treasury as Permitted by the 1910 Amendment

In this connection the Central Hudson Gas & Electric Company, in July, 1912, applied for permission to issue stock to the amount of $216,000 for the reimbursement of its Treasury.[13] Of this amount it was intended

[11] In a similar case (The Matter of the Application of the Niagara Light, Heat & Power Co., 2 P.S.C.R., 2nd Dist., N. Y., 90, (decided June 29, 1909) the Commission objected to an item of $12,000 because of lack of definiteness, and expressed itself as follows:

"It is not shown specifically by the evidence for what purposes this indebtedness was incurred. Any general evidence that it was used for additions and betterments amounts to nothing. The circumstances of the case require that the applicant show clearly and positively, before the application is granted in this particular, that this indebtedness was incurred for proper capitalization purposes and not merely for the purpose of paying operating expenses."

Again in the Binghamton case, 2 P.S.C.R., 2nd Dist., N. Y., 171, (decided August 4, 1909), a part of the bonds were asked for purposes of refunding; the remainder of the amount asked for, consisting of both stocks and bonds, was $230,000. Of the proceeds only $158,000 were required to pay outstanding notes. What was to be done with the remainder? The application pointed out nothing which came within the purposes enumerated in the law. The company desired to acquire no property; it did not ask to improve or extend its plant or distributing system; it suggested nothing for improvement or maintenance of its service; it named no obligations. The company apparently desired to accomplish a reimbursement of its treasury, as the alleged indebtedness was not owing to third parties, but to itself. Hence it came under the principle laid down in the Lehigh and Hudson River Railway case.

[12] Matter of Application of the Bronx Gas and Electric Company, 2 P.S.C.R., 1st Dist., N. Y., 178. Opinion adopted January 14, 1910.

[13] *Capitalization of Penalty Disapproved*

In connection with the above, we might cite the application of the New York Dock Railway Company, a subsidiary corporation of the New York Dock Company,

to distribute $116,000 as a stock dividend of 10 per cent to its stockholders of record, and to place the balance of $100,000, par value, in the hands of trustees to be used for the benefit of its employees as set forth in an agreement of trust.

It was held that the company could not issue stock for any purpose whatever except upon order of the Commission, and that the latter could only approve an issue for the purposes enumerated in the capitalization sections of the Public Service Commissions Law. The two cases previously discussed in this connection were cited to the effect that the payment of stock dividends was not one of the purposes for which capital stock or obligations in the form of dividends-warrants could be issued under the statute.[11]

The second purpose, the devoting of $100,000 of the proceeds of the proposed stock to the establishment of a benefit fund for employees, "though entirely commendable in itself," the Commission held was not a purpose of capitalization enumerated in the Law for which stock could be issued, although it was granted that the company was entitled to create from its income a trust fund for the benefit of its employees.

By an amendment to the Public Service Commissions Law adopted in 1910 there was added to the capitalization sections of the Law a clause relating to stock or bond issues for the purpose of reimbursement of monies actually expended from income or other treasury funds, except for maintenance of service and replacements. This amendment, however, the Second District Commission held in the Central Hudson Gas

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which asked authority to apply the proceeds of a proposed issue of stock to the discharge of obligations incurred by it in the sum of $6,250, as payment for the past use and operation of the streets by railroad tracks previously operated by the New York Dock Company. The latter had possessed no franchise for such use of the streets. The city, knowing the intimate relations existing between the Dock Company and the Dock Railway, had made the payment of compensation for this illegal operation of the streets by the Dock Company a condition of the granting of a franchise to the Dock Railway Company, instead of attempting to collect from the Dock Company through the courts, as this would have held up the operation of the property by the Dock Railway Company.

The First District Commission held that expenditure for such purposes, relating to a period prior to the formation of the applicant corporation, could not be capitalized, as such action would be tantamount to the capitalization of property which had ceased to exist. See Matter of Application of the New York Dock Railway, 4 P.S.C.R., 1st Dist., N. Y., 94. Opinion adopted March 28, 1913.

[11] Matter of Application of Central Hudson Gas and Electric Company, 3 P.S.C.R., 2nd Dist., N. Y., 380. Decided July 16, 1912.

and Electric case, referred to property acquisitions or property improvements or betterments, and in no sense to the absorption of a company's book surplus by the issuance of stock as a dividend or of stock to obtain monies with which to set up a benefit fund.

The Commission here took occasion to define the application of the reimbursement clause and its non-relation to dividends. If, it held, an issue of stock was approved to reimburse the treasury of the company for money expended from income on improvements or betterments of its property, and the monies were restored to the treasury of the company, the board of directors of the company could then determine whether or not such monies might properly be used for dividend purposes. It was true that stock authorized to be issued and sold for account of reimbursement could be sold to the stockholders of the company and the proceeds immediately declared as a dividend to the stockholders of the company, and so in effect be a stock dividend. This, it was held, would be in accordance with the law, and for a purpose prescribed in the law, that of reimbursement, and in the eyes of the law would not be a stock dividend.

The Law as originally passed in 1907 had been generally regarded as defective in that a company subject to its provisions was unable to return to its treasury by stock or bond-issue funds which it had expended from income for improvements or extensions. Permission to issue securities for such purposes could have been obtained before the expenditures were made, or, if short-tem obligations had been issued for them, securities could then be issued for the refunding or discharging of these obligations. Simple reimbursement of the treasury, however, was not permitted. By the 1910 amendment it was sought to remedy this defect and permit reimbursement of a company's treasury whenever it could show clearly that the *original expenditure* has been made for purposes enumerated in the Law.

Privilege of Issuing Evidences of Indebtedness for Twelve Months or Less is not to be Used as a Subterfuge

The Public Service Commissions Law allows the issue of evidences of indebtedness for twelve months or less without the consent of the Commission, but such a provision is intended for purposes of temporary emergency, and not as an excuse and a means for the later issuing of long-term bonds without the consent of the Commission.

In July, 1908, a joint application was made to the First District Commission for the execution of mortgages to secure demand certificates by

the Nassau Electric Railroad Company to the amount of $5,000,000, and by the Brooklyn Union Elevated Railroad Company to the amount of $20,000,000.[15]

The Brooklyn Rapid Transit Company, which controlled both the applicants, had in 1902, executed to the Central Trust Company as trustee, a 100-year mortgage to secure bonds to the amount of $150,000,000. In connection with the mortgages applied for, the applicants had entered into an agreement with the Brooklyn Rapid Transit Company by the terms of which monies needed by the applicants were to be furnished through demand certificates sold to the Brooklyn Rapid Transit Company. The latter agreed to buy the same from time to time and was then to take them to the Central Trust Company and receive from the latter authentication and delivery to it of 100-year bonds of the Brooklyn Rapid Transit Company secured by the $150,000,000 mortgage above mentioned.

The Commission held in this case that while the issue of evidences of indebtedness maturing in twelve months or less was not within its jurisdiction, the subsequent use made of them in the plan outlined, that is, the issuing of such certificates pledged by mortgages and the subsequent pledging of the same as security for the issue of 100-year bonds of the Brooklyn Rapid Transit Company would constitute an evasion of Section 55 of the Public Service Commissions Law, and that the Commission in its duty of supervising the capitalization of all public service corporations within its jurisdiction, should refuse consent to such mortgages. Such a plan, it was held, might be used to nullify the power of the Commission in respect of its control over issues of long term bonds.

Another closely related case was the application of the Delaware & Hudson Railroad for permission to refund certain notes coming under the "twelve months or less" classification. They amounted in the aggregate, to about twenty million dollars, and extended over a period of three and one-half years, many of them having been renewed from time to time.

It appeared that many corporations in New York State had gotten into the habit of contracting large amounts of indebtedness by means of note issues maturing in periods of twelve months or less. These

[15] Matter of Application of the Brooklyn Union Elevated Railroad Company, 1 P.S.C.R., 1st Dist., N. Y. 277. Also Matter of Application of the Nassau Electric Railroad Company (same ref.). Opinion adopted July 17, 1908.

See Babylon case, 1 P.S.C.R., 2nd Dist., N. Y. 132, and Erie case, 1 P.S.C.R. 2nd Dist., N. Y. 115, referred to previously.

issues would be renewed in whole or in part for another like period. The renewals were often accompanied by additions to existing indebtedness of other large note issues. Such renewals, part payments and increases were continued indefinitely. With a large part of the proceeds of such notes there was often carried on a series of operations covering the acquisition of land, railways or parts thereof, stocks or bonds of railroad companies, track construction, sidings, terminals, purchase of equipment, etc. In such cases the accounts of the disposition of proceeds of the notes were so thoroughly confused with general treasury disbursements, particularly as regarded construction and equipment, that the separation of such accounts was either impossible or required months of work.

The "twelve months or less" privilege, the Commission held, was for the purpose of enabling a corporation to contract temporary loans which should be met at maturity and not, to quote from the opinion in this case,

> to operate as a license whereby, through successive renewals with extensive additions of new short-time notes issued (the amounts frequently combined together in one or several notes), a huge mass of obligations running over a series of years is piled up to become eventually the subject of application for leave to fund by mortgage and an issue of long-time bonds.[16]

The Commission held that even granting that there existed a technical legal right to fund such notes by new issues of other notes and the application of their proceeds to the discharge of the old notes falling due, there must be a limit, in practice, to the exercise of such a right. When such a plan was carried to the extent of covering several times of maturity and extending through several years, the Commission said,

> it is evident that the intent of the law is being evaded, and that the corporation is accomplishing by indirection that which the law forbids shall be done directly, namely, the issuing of evidences of indebtedness carried without actual payment throughout a period of more than twelve months without first obtaining the approval of this Commission.[17]

Under such practice the application of the money derived from the note issues often dated so far back and had become so intermingled with expenditures from other sources which might have been applied to the same purposes, that it was impossible to determine whether the money so expended had been for value and for the purposes prescribed in the

[16] Matter of Application of The Delaware and Hudson Company, 1 P.S.C.R., 2nd Dist., N. Y. 242. Decided July 7, 1908.

[17] See 1 P.S.C.R., 2nd Dist., N. Y. Bottom page 267 and middle page 268.

statute. The applicant corporation itself was often unable to make the complete showing contemplated in the statute because of the failure to keep accurate accounts of the application of the proceeds of such short time loans, and a detailed record of unit-costs for construction and improvement, as distinguished from maintenance. In such cases the Commissions had no satisfactory evidence upon which they could assert that a proposed security issue for the refunding of such short time obligations was reasonably required for the purposes of the statute. Hence an application might have to be denied, and the corporation, in effect, penalized, or, at least, deprived of relief to which it might actually be entitled under the Law.

The Second District Commission suggested that in a case where such short time loans were about to mature, and an extension was deemed necessary, application should be made to the Commission for permission to issue notes running for more than a year to cover the maturing issues, or else, issue stock or bonds. The disbursements under review would then be so recent that the purposes to which they had been applied could readily be ascertained.[18]

[18] In another instance, the Consolidated Gas Company of New York City had advanced money to the Astoria Light, Heat and Power Company to the amount of $14,200,000 upon 6 per cent notes. (See Matter of Application of the Astoria Light, Heat and Power Company, 5 P.S.C.R., 1st Dist., N. Y., 122. Opinions filed March 3, 1914.) The First District Commission had its accounting staff make an examination for the purpose of ascertaining whether or not the proceeds of these notes had been applied for purposes properly chargeable to capital. On account of the magnitude of the expenditures and the mass of vouchers to be examined the Commission's engineers and accountants adopted what is known in statistics as the "sampling" process. In this way they investigated and checked up about 70 per cent of the vouchers containing the essential items. These vouchers, they testified, had been selected at random and without any suggestions from the officials of the Company. The representatives of the Commission testified that each item examined was found to be a reasonable charge for the property, services or labor received or performed; that each item had been required for the immediate supply of gas and was an addition or betterment to the company's property. The majority opinion held that such a check upon the application was sufficient without going into the full 100 per cent of the amount.

Commissioner Maltbie, however, submitted a dissenting opinion in which he contended that upon the basis of such a partial examination it was impossible for the Commission to certify that all the expenditure had been necessary and reasonable, as was required by the statute. He contended that such partial audits did not satisfy the requirements of the Law. The majority opinion insisted that it would be foolish for the Commission to commit itself to the practice of examining every item in such a case as it would, in many instances, cause intolerable delay in taking action upon the issue of securities asked for, and would be an unreasonable burden upon the cor-

Are Railroad Securities "Property"?

In this case also, that of the Delaware and Hudson Company,[19] the question came up as to whether railroad securities were "property" in the meaning of the Public Service Commissions Law, that is, as one of the objects for which securities could be issued.

The Delaware and Hudson Company in order to finance certain Canadian railroad projects (The Quebec, Montreal and Southern, and the Napierville Junction, Railway companies) had issued notes, with the proceeds of which it had made advances to these companies and had received certificates of indebtedness which would later be exchanged for the bonds of the companies. The Second District Commission held in this case that "railway stocks, railway bonds and railway certificates of indebtedness are property," and that the proceeds of the notes sought to be refunded had been expended for the "acquisition of property" as authorized in the statute.

When is the Purchase of Securities of One Railroad by Another "Reasonably Necessary"?

On the other hand, if this were a mere investment, while it might constitute "property" within the meaning of the statute, it would not be "reasonably necessary," which is also a requirement of the statute, and should be made, if at all, from surplus.

It was shown in this case, however, that these roads had been built under the full control of the applicant, and were intended to be feeders

porations which had to call their employees from their regular duties to assist the representatives of the Commission.

The reasoning of the majority seems lacking in weight. The "sampling" process is undoubtedly a loose way of checking up specific items and if adopted in such cases might become subject to unforeseen abuse. The position of the dissenting commissioner seemed to be much more in keeping with the spirit of the Public Service Commissions law.

The 1910 amendment to the Public Service Commissions Law, which we have discussed above, laid particular emphasis upon the necessity of clearness in the records of expenditures incurred in this way. It provided that reimbursement of a company's treasury could be accomplished by the issue of securities only "in cases where the applicant shall have kept its accounts and vouchers of such expenditure in such manner as to enable the Commission to ascertain the amount of moneys so expended and the purpose for which such expenditure was made. . ." See also Matter of Application of The Long Island Railroad Company, 2 P.S.C.R., 2nd Dist., N. Y., 275. Decided November 18, 1909.

[19] Matter of Application of The Delaware and Hudson Company, 1 P.S.C.R., 2nd Dist., N. Y. 242. Decided July 7, 1908.

to its main system. Being in foreign territory, ownership by a separate corporation was necessary. These roads, the Commission held, would form an important addition to the applicant's system. Therefore, it was held, the investment in the certificates had been "reasonably necessary."

General Tests for the Refunding of Note Issues

The question of the refunding of note issues was an important phase of the Delaware and Hudson case, just discussed, and the Commission took the opportunity to state its general conclusions upon this subject in the following language:

> We must apply the same test to cases where it is sought to issue bonds to refund or discharge notes that we employ upon applications to issue bonds to acquire property, construct additional line or make improvements generally. That test is whether the particular matter is the proper subject of capitalization. Where property is sought to be acquired by means of a bond issue, or notes covering the acquisition of property are sought to be refunded by a bond issue, determination of the question whether the capital to be secured by such an issue is reasonably required involves inquiry as to the character and use of the property with reference to the general business and public duties of the applying corporation, and in all such cases the Commission must distinguish between what are merely investments in disconnected properties and what are acquisitions of property having some definite useful relation to the public service operations of the corporation.[30]

The refunding of certain other items in the application was held to be unwarranted, upon the evidence produced, and no action was taken upon them. A continuance of the application was granted in this respect for the submission of further evidence, if the applicant so desired.

A few months later these items were again brought before the Commission.

Issue of Bonds for Purchase of a Disconnected Property Held to be "Not Reasonably Necessary"

In one of these items the Delaware and Hudson Company had charged $4,665,295 against the purchase of 75,000 shares of stock of the United Traction Company. Meantime, the Northern New York Development Company, a dummy corporation which the Delaware and Hudson used as its agent in acquiring properties, had, by order of the Delaware and Hudson, purchased virtually the entire stock and bonds of the Hudson Valley Railway Company, the Delaware and Hudson advancing the amount mentioned above. Before the completion of this

[30] See 1 P.S.C.R., 2nd Dist., N. Y. Bottom of page 275.

purchase the Delaware and Hudson itself had purchased the entire capital stock (50,000) shares of the United Traction Company, for which it had paid $150 a share, or a premium of $2,500,000 on stock of the par value of $5,000,000. The Delaware and Hudson then determined to have this $2,500,000 premium repaid to itself in new stock of the United Traction Company, and also to have the latter issue other $5,000,000 of stock for the purpose of assuming the Hudson Valley purchase from the Northern New York Development Company. This increase of 75,000 shares was permitted by the existing Board of Railroad Commissioners and the Delaware and Hudson in effect thereby caused an issue of $2,500,000 new stock of the United Traction Company to itself, for which it paid nothing, and which it had been able to do through its ownership of all the stock of the Northern New York Development Company and the United Traction Company.

Upon the original application the Delaware and Hudson had asked leave to issue bonds upon its steam railroad properties with which to refund the items here involved, on the basis of the expenditure of the proceeds for the purchase of 75,000 shares of United Traction stock. In the present case it based the proposed new issue upon the purchase of the Hudson Valley securities above described.

The Delaware and Hudson did not, at this time, own a single security of any kind of the Hudson Valley Railway Company. It had had control at one time, through its purchasing company, but, instead of transferring these securities to its own name, it caused the Development Company to transfer them to the United Traction Company, and took an assignment of the Traction Company's certificate of indebtedness issued to the Developemnt Company in payment for the sale of these Hudson Valley securities. It had advanced money to the Development Company to purchase the Hudson Valley securities, and if those securities had then been taken over by the Delaware & Hudson its ownership would have been direct and the transaction complete. But it then caused the sale to the United Traction Company and accepted therefor the latter's certificate of indebtedness for $7,500,000 in return for an expenditure of approximately $5,000,000. This was followed by an exchange of the certificate for $7,500,000 of new United Traction stock. It would have seemed logical, therefore, that as a result of these transactions, these notes of the Delaware and Hudson, which it now sought to refund, actually represented the purchase of 75,000 shares of United Traction Company stock, and nothing else.

If it were assumed that the note obligations in question represented money paid for the Hudson Valley securities, then it would have seemed that the Delaware and Hudson had received the securities of the Hudson Valley, which it claimed were worth the amount of the notes (approximately $5,000,000) and in addition $2,500,000 of stock of the United Traction Company which could be legally issued only for full value. This left $2,500,000 as representing Hudson Valley securities. The Commission held, that for the purposes of this application, it would regard the whole series of transactions as representing solely a final investment in stock of the United Traction Company. The whole proposition narrowed down, in the Commission's view, to the question whether under a new mortgage vesting solely upon the applicant's steam railroad properties there should be allowed a bond issue for the refunding of notes the proceeds of which had been finally devoted to the purchase of United Traction Company stock. For the purchase, the Commission held, was merely an investment in stock of a company operating a disconnected property which had no necessary or useful relation to the railroad company's general operations. Such an investment, the Commission held, if made at all, should be drawn from surplus funds. "We cannot say," the Commission said, "that such capital to be so secured is reasonably required by this common carrier corporation for purposes defined in the statute."

The applicant corporation had contended that in cases where the proceeds of note issues had been used for the acquisition of a disconnected property of any kind, the value of which was less than the sum so expended, the action of the corporation's board of directors should be accepted without inquiry.

Attitude of Commission Toward Obligations Issued Prior to July 1, 1907

The applicant corporation, The Delaware and Hudson Company, further contended that bonds should be authorized as a matter of course when the note obligations upon which they were to be based had been incurred prior to the going into effect of the Public Service Commissions Law. The Commission held, in this case, that such a position was untenable, and stated "that the Law took effect on July 1, 1907, and thereafter all new stock, bonds, notes for more than one year, and other evidences of indebtedness could only issue in accordance with its provisions."[21]

[21] See 1 P.S.C.R., 2nd Dist., N. Y., top of page 407.

Obligations entered into prior to that date and for which new bonds or long time notes were later sought to be issued, the Commission held, must be thoroughly inquired into, to the end that the Commission should satisfy itself that the capital proposed to be raised was or was not reasonably required. This was not meant in the present case, the Commission pointed out, to be a review of the action of the Board of Directors in issuing notes and purchasing property before the law came into force, nor a discussion of the right of the company under prior existing law to purchase at will the securities of traction or other companies, nor a review of the action of the Board of Railroad Commissioners in authorizing the increase of the traction company stock. It was simply, as the Commission expressed it, to the effect that "whatever was done rightfully or wrongfully before, now under this law the necessary showing must be made to warrant issuance of new bond capital. . . ."

The practical situation facing the Commission was commented upon in part by Commissioner Decker, as follows:

> The note obligations involved are lawful obligations resting upon the corporation, and no matter how the proceeds were expended, the debt must be paid. . . . These notes are being carried now necessarily on short terms, one year or less, and the interest charges are comparatively high. It is important that they should be discharged by actual payment or evidences of debt running for a period of more than one year. The obligations were contracted in the exercise of a legal right by the corporation, and the proceeds were devoted to the purchase of securities at a time when the corporation was entitled to acquire the stock of other railroad corporations and street railroad corporations without asking permission to do so from any board or tribunal. This Commission is without power to require the corporation to divest itself of title to these or any securities or property, and the law now in force specifically declares that its provisions shall not 'be construed to prevent the holding of stock heretofore lawfully acquired.'[22]

The Commission held therefore, that the acquirement of the traction securities must be treated as an accomplished fact, and, for the purposes of this case, as a lawful act, and that in this respect only did note obligations created prior to the passage of the Public Service Commissions Law to raise funds with which to acquire property, including railroad securities, differ in character and treatment from such obligations issued after that law went into effect. Since then the consent of the Commission has been, of course, a prerequisite to any such purchase or taking over of the stock of one corporation by another.

In short, the Commission, while granting the legality of the purchase of these securities, and the necessity for the discharge of the notes underlying them, would not endorse their funding by means of the long term

[22] See 1 P.S.C.R., 2nd Dist., N. Y., top of page 408.

bonds applied for, and suggested the possibility of a mortgage covering all of the applicant's property, or at least the traction property in question, instead of a mortgage covering only the applicant's railroad property. It was further suggested by the Commission that upon such mortgage five year notes could be issued for which these or other securities owned by the company could be put up as collateral security, or, further, the issue of short time general income or debenture bonds with provision for actual payment at maturity.

The applicant corporation's plan would have charged the railroad alone for a period of thirty-five years with a debt which had no relation to the railroad or its operation, and, for the reasons stated, this part of the application was denied.

Purchase of Coal Lands by a Railroad Corporation

The third disputed item in this somewhat involved case was the proposed refunding of note obligations to the amount of $2,500,000 for advances made to a subsidiary (The Hudson Coal Company) for the purchase of certain coal lands in Pennsylvania. These coal lands were not covered by the mortgage, which, as stated before, was based upon the applicant's railroad property exclusively.

The Delaware & Hudson's charter gave it power to carry on business both as a common carrier and as a coal producer, but as a common carrier it was subject to the provisions of the Public Service Commission's law, and as such it was applying for bonds.

The evidence showed that the coal lands were worth eight times as much as the amount of the indebtedness ($2,500,000), and that while the Delaware and Hudson had not taken title to them, it had entire control of them through stock ownership of subsidiaries, and could at any time cause mortgages to be issued upon them for the refunding of the advances which it now sought to refund by bond capital upon its railroads. And, of course, if the Commission should grant the latter application, it could still go ahead and mortgage said coal lands without any permission from the Commission, in spite of the fact that the railroad property would be burdened with bonds whose proceeds were invested entirely in the purchase of the lands.

In the first place, the applicant claimed that a far larger amount had been spent upon improvements to the railroad property than upon the development of the coal-mining company, whereas the coal lands paid a much larger proportionate return. The Commission held that, assuming that such a large amount of money as stated had been expended upon the

railroad property for improvements, and that the same had not already been made the subject of capitalization, this fact in itself would constitute no justification for "an otherwise improper addition to the debt burden borne solely by the railroad."

Secondly, it was urged by the applicant that the value of the railroad property depended largely upon its use in the shipment of coal derived from such properties, and that the large revenues received from this source went a long way toward meeting operating expenses and fixed charges, with the result that the cost to the public of using the railroad was much less than it would have been without this large source of traffic. The claim was, in brief, that the applicant's large private business as a coal-carrying corporation was necessary to its success as a common carrier corporation; that this business was of such advantage in enhancing the value of the railroad property and in making possible lower rates to the public, that the cost of additional coal lands deemed necessary for the permanence of this traffic could justifiably be added to a funded debt resting only upon the applicant's railroad property.

The evidence showed that the coal properties were amply able to carry their own fixed charges, and that the acquisition of the coal lands was to the Delaware and Hudson as a railroad corporation an advantage too remote to make the purchase price or a part of it a proper charge upon its railroad property. The Commission held that "the proposed bond issue upon the railroad property alone to refund or discharge obligations incurred to pay for coal lands, a totally disconnected property, which it holds and will use in its capacity as a producer and shipper of coal, relates to a kind of capital not shown to be reasonably required in this case."[23]

The applicant appealed to the courts, and the Appellate Division of the Supreme Court reversed the order of the Commission. The Commission then carried the case to the New York Court of Appeals with the result that the order of the Lower Court was upheld in a decision rendered December 7, 1909.[24]

[23] See 1 P.S.C.R., 2nd Dist., N. Y., page 422.

[24] *People ex rel The Delaware & Hudson Co. v. Stevens, 197 N. Y. 1*

The Delaware & Hudson decision has been so widely heralded as a check upon the powers of the Public Service Commissions that we have taken the liberty of quoting at length from it regarding the main issues involved. "We do not think," said the Court "the legislation alluded to (the Public Service Commissions Law) was designed to make the commissioners the financial managers of the corporation, or that it empowered them to substitute their judgment for that of the Board of Direc-

In connection with the notes issued by the applicant for the purchase of coal lands, the court pointed out that these notes were conceded by the Commission to be valid obligations of the company; that they had been given for the acquisition of the property; that the lands so acquired

tors or stockholders of the corporation as to the wisdom of a transaction, but that it was designed to make the commissioners the guardians of the public by enabling them to prevent the issue of stock and bonds for other than the statutory purposes. . . ."

The Court denied the power of the Commission in refusing permission to the Delaware and Hudson Company to refund the Hudson Valley notes in the following language. "In regard to the notes issued for the purpose of acquiring the stock and securities of the Hudson Valley Railway Company, there is no question made with reference to the amount or their validity. . . . The learned commissioner, (Commr. Decker had written the opinion of the Commission) however, reaches the conclusion that, notwithstanding the fact that the transaction was lawful, and that the notes were the valid obligations of the corporation, the purchase of the Hudson Valley securities was an unfortunate one for the company. . . . *This, we think, would be substituting the judgment and discretion of the commissioners for that of the directors and stockholders of the corporation.* If such was the purpose and intent of the statute, a doubt might arise with reference to its constitutionality. For, ordinarily, the ownership of property carries with it the right of occupancy and management, and should a statute deprive the owner of the right to manage, it would, under ordinary circumstances, undermine his right to protect and make his property remunerative. . . . Assuming that the purchase was unfortunate and that the company has lost heavily thereby, still the commissioners conceded that it was made at a time when no consent of the railroad commissioners or of the Public Service Commission was required, and that, therefore, the purchase was legal, and one which the company had the right to make. . . . They, the notes, were given for the acquisition of property, which is one of the four purposes designated by the statute for which bonds may be authorized to issue. Having been given for the acquiring of the property of another railroad, they are properly classified as capital and are, therefore, brought within the express provisions of the statute under which the application was made. While, as we have stated, the ownership of property ordinarily carries with it the right of management the duty devolves upon the owner to so manage as not to have it become a nuisance or unnecessarily infringe upon the rights of others. *It was, therefore, evidently the legislative intent in the enactment of this provision that the commissioners should have supervision over the issuing of long time bonds to the extent of determining whether they were issued under and in conformity with the provisions of the statute for the purposes mentioned therein, or whether they were issued for the discharge of the actual and not the fictitious debts of the company, or whether they were issued for the refunding of its actual obligations, and not for the inflation of its stocks or bonds.* Beyond this, it appears to us that the powers of the Commissioners does not extend, unless it may pertain to the power to determine whether an obligation should be classified as operating expenses and as to whether such expenses should be paid by obligations running beyond a year. We, therefore, conclude that, as to the Hudson Valley securities, so-called, the application of the relator company should have been granted."

(Note—Italics not in original.)

or the amount so paid had become capital of the company; that they presented the same question as that involved in the Hudson Valley securities, and should have been granted.

The Delaware and Hudson decision is referred to again and again, and yet one is puzzled as to what it actually decided. One point emphasized by the Court was the fact that the purchases in question were made prior to the enactment of the Public Service Commissions Law, and that, therefore, they were legal. Its lack of specific application to other cases seems to be evidenced in part by the wide use made of it by counsel of public utility companies who had nothing else to use and who desired to interpret the Law so as to modify the powers of the Commissions to suit their own needs. The decision, like that of the United States Supreme Court in the Consolidated Gas case, seems to have been more or less peculiar to the case involved, rather than of general application, and to indicate more than anything else, a trend upon the part of the courts to keep the Commission closely confined to the powers granted them under the Public Service Commissions Law.[25]

Approval of Issue of Securities for Purchase of Property Not Directly Used in the Public Service

The Watertown Light & Power Company had, with the consent of the former commission of Gas & Electricity, and by means of securities authorized by that body, purchased the property and water power of H. Remington & Sons Pulp and Paper Company. The possibilities of hydraulic power development in this property were regarded as very valuable, but the whole property had to be purchased in order to acquire them.

[25] In the Binghamton case (Matter of Application of Binghamton Light, Heat and Power Company, 2 P.S.C.R., 2nd Dist., N. Y., 171. Decided August 4, 1909), the applicant corporation cited the decision to support its contention that the Commission had no right to refuse approval of the securities because they represented replacement expenditures. The New York Court of Appeals finally passed upon the case and in its decision discussed the Delaware and Hudson decision to the following effect. (People ex rel. Binghamton Light, Heat and Power Company vs. Stevens, 203 N. Y., 7. Decided Oct. 3, 1911):

"The court in that case (Del. and Hud.) in referring to the intent of the legislature, said that by its enactment (Public Service Commissions Law) the commissioners should have supervision over the issuing of long time bonds to the extent of determining whether they were issued under and in conformity with the provisions of the statute for the purposes mentioned thereon, or whether they were issued for the discharge of the actual and not the fictitious debts of the company, or whether they were issued for the refunding of its actual obligations and not for the inflation of its stock or bonds; and

The property was devoted chiefly to pulp mill operations and consisted of about thirty-five acres of land through which flowed a river. The water-power possibilities were only partially developed. Upon this property the Watertown Company had expended some $114,000, which it wished to refund by the issue of securities.[26] Also, in the list of expenditures of the Watertown Company upon its own plant there occurred an item "Improvements to flats . . . $748.00," and from this it appeared that upon a piece of real estate which the company owned in connection with its electric business, it had erected a large building which it let out as stores and flats, but that none of the building was being used in the business of furnishing light and power.

These two matters brought up the question of the authority of the Commission to allow capitalization for improvements other than directly for public service.

Here was a case of a light and power company owning a pulp mill and making large investments in developing water power, which, whether or not it might ultimately be required for public service, was for the present, and for a long time to come, to be used in the manufacture of pulp. A building had been erected by the same company upon real estate which it owned, but which it rented out and did not use for the public service. No doubt such investments made from earnings would not be open to criticism, but were such investments the proper subject for the issue of securities?

It was true that the mill property had nothing to do with the public service other than that the water-power developed upon it might be needed at some future time. Still, the Commission reasoned, it would certainly not be public policy to allow the property to deteriorate or remain undeveloped; but, on the other hand, as a public utility the company could not borrow money without the consent of the Commission.

As to the real estate, the officers of the company stated that they expected at some future time to make use of the building in the public

continuing, the court further says: 'Beyond this it appears to us that the power of the commissioners does not extend, unless it may pertain to the power to determine whether an obligation should be classified as operating expenses and as to whether such expenses should be paid by obligations running beyond ayear. (Pg. 13). The question as to whether the commission has authority to classify the expenditures of a corporation and ascertain what part thereof should be charged to capital account and what part to operating expenses was thus expressly reserved for further consideration."

[26] Matter of Application of the Watertown Light and Power Company, 1 P.S.C.R., 2nd Dist., N. Y., 496. Decided March 9, 1909.

service, although it was not necessary to their business at present. Should this real estate be allowed to lie idle because it was not at present directly related to the public service? Must the company dispose of this property, which might in the future become necessary to its business because it could not at present make such use of it?

Section 69 of the Public Service Commissions Law stated that "electrical corporations organized or existing . . . under or by virtue of the laws of the State of New York, may issue stocks, bonds, notes, or other evidences of indebtedness . . . when necessary for the acquisition of property, the construction, completion, extension and improvement of its plant . . . or for the improvement or maintenance of its service," upon the proper order of the Commission.

If an electrical corporation, the Commission reasoned, owned a plant for the manufacture of electricity, and needed to extend its service to give immediate adequate service, such action would not be a matter of dispute. If, in order to give such service it had to purchase adjoining property, such action would be approved. If its business were growing rapidly, and it needed the extension for future development, but had the chance to purchase now, certainly such action should be approved.

If, upon the property purchased, there were a building, which, in due course, would be demolished to make way for extensions of plant, should not such building in the meantime be given necessary repairs, and made remunerative, rather than left idle?

As to the time when such properties would be actually needed in the public service, the Commission held that it was futile to lay down any rule; the proper solution seemed to be to construe the statute in the light of intelligent business judgment and upon the merits of individual cases. "A public service corporation" said the Commission, "should not engage permanently in any other business than that for which it is incorporated, but where it is desired to equip temporarily property which is held for future public service, and such property can be shown to be ultimately desirable and temporarily not a burden upon such public service, this Commission should not withhold its approval."

It was held that the purchases of the pulp mill property, with its valuable water power, was a proper business undertaking for the light and power company, as it was based upon its public service capacity toward the future development of the city, and that, if, in the meantime, it were allowed to lie idle, it would be a drain upon the company, and, indirectly, upon its consumers.

PART FOUR

REFUNDING AND REORGANIZATION

Refunding, in its broadest sense, includes reorganization, which is really a special kind of refunding consequent upon a sale at foreclosure and change of ownership. Legally, a new corporation comes into existence with reorganization, while with the ordinary kind of refunding, the corporation continues as before.

CHAPTER XIII

REFUNDING

Under the heading of refunding there will be considered only obligations running for more than twelve months. Obligations running for twelve months or less do not come within the jurisdiction of the Commissions,[1] and the refunding of such obligations with securities running for more than twelve months constitutes an issuance of new securities.

One of the purposes for which the Law provides that a corporation may, with the approval of the Commission, issue stocks, bonds, notes, or other evidences of indebtedness (payable at periods of more than twelve months) is "for the discharge or lawful refunding of its obligations." In considering applications for permission to issue securities for the purpose of refunding bonds or other obligations issued subsequently to the establishment of Commission-control, the procedure is largely routine. For the original issue has been subjected to investigation by the Commission, and any questions arising have to do chiefly with changes in the form or conditions of the new securities, and not with the propriety of the issue as a capital charge. Thus it may be necessary to refund a bond issue paying four per cent with a new issue carrying a five per cent return, due to changes in the condition of the money market, or a corporation may propose to replace a maturing bond issue with preferred stock.

Commissions Should not be Compelled to Authorize the Refunding of Obligations Simply Upon Proof that they are Lawful

In the matter of applications for permission to issue securities for the purpose of refunding bonds or other obligations issued prior to the establishment of commission-control, all public service commissions have a large amount of discretion, and the question has arisen whether such outstanding obligations should be permitted to be refunded simply upon proof that they are lawful, or whether there should be investigation as to the purposes for which the outstanding issue was originally made,

[1] The Public Service Commissions Law, Sec. 55, provides as follows: "Such common carrier, railroad corporation or street railroad corporation may issue notes for proper corporate purposes and not in violation of any provision of this chapter or any other act, payable at periods of not more than twelve months without such consent, but no such notes shall, in whole or in part, directly or indirectly be refunded, by any issue of stock or bonds or by any evidence of indebtedness running for more than twelve months without the consent of the proper commission." See also Secs. 69, 82, and 101.

and the manner in which the proceeds were utilized. The New York Commissions have taken the position that securities for the refunding of outstanding lawful obligations should be authorized only after investigation of the original expenditures. The First District Commission has assumed discretion in the matter of sanctioning securities to refund ouststanding obligations, and in such cases has based its considerations upon the purposes for which the original funds were expended, the value of the applicant's property, and its earnings.

In connection with the application of the Dry Dock, East Broadway and Battery Railroad Company to refund certain obligations, the corporation contended that it was entitled to the approval of the proposed new securities upon proof that the securities to be refunded were lawful, regardless of the value of the property, or the adequacy of earnings to meet interest charges.[2]

This petition was subsequently denied and Commissioner Maltbie, in writing the majority opinion, pointed out that if, as seemed probable, the certificates which the company sought to refund with fifty-year bonds had originally represented surplus built up out of earnings, that surplus or the property which represented it might have disappeared, and yet the company claim the right to refund indefinitely. This would result in permitting a company to do indirectly, and with the approval of the Commission, what the Public Service Commissions Law was enacted to prevent, namely, the issue of securities without corresponding value. This opinion held as follows:

> It is incumbent upon the Commission, before it allows the certificates to be permanently refunded in bonds, to find what has become of the property they originally represented, if they represented any. If it does not exist and if there is no equivalent, the Commission has no power to permit this deficiency to be capitalized by the issue of fifty-year bonds.[3]

As regards the claim of the company that consideration by the Commission of the earnings and their adequacy to pay interest charges was irrelevant, the opinion held that

> the Commission would become ridiculous if it did not consider probable earning capacity and would authorize bonds to be issued upon which interest could not be paid. . . . No issue of bonds can be said to be "necessary" in any sense of the word, if the inevitable or probable result would be the insolvency of the corporation issuing the securities. . . .[4]

[2] Matter of Application of the Dry Dock, East Broadway and Battery Railroad Company for Permission to Issue Bonds, 5 P.S.C.R., 1st Dist., N. Y., 141. Opinions filed March 3, 1914.

[3] See 5 P.S.C.R., 1st Dist., N. Y. Bottom page 166.

[4] See 5 P.S.C.R., 1st Dist., N. Y. Bottom page 178.

It was further pointed out that what records were available showed that parts of the indebtedness to be refunded represented a scrip dividend as well as replacements and renewals. Withdrawals had not been credited to capital account and dividends had been paid which had not been earned. In conclusion, the opinion held that

upon the facts the Commission has no power under the law to approve the pending application, and to do so would be to disregard one of the fundamental purposes for which the Public Service Commission was created.[5]

In a Second District case, the application of the Delaware and Hudson Railroad to issue bonds, a portion of which were to be used to refund certain obligations incurred prior to the going into effect of the Public Service Commissions Law, the company claimed that bonds to refund such obligations should be authorized as a matter of course.[6] The Commission held this position to be untenable; that the law took effect July 1, 1907, and that thereafter securities could be issued only in accordance with its provisions; that obligations entered into prior to that date for which it was proposed to issue new securities must be thoroughly inquired into, so that the Commission could satisfy itself that the capital to be raised was "reasonably required."

Permission to Execute Refunding Mortgage Based upon Thorough Investigation by Commission

The Interborough Rapid Transit Company applied for permission to execute a mortgage upon its property to secure the issue of bonds to the extent of $55,000,000. A large part of this was to be used to refund existing issues. The Commission, after making a thorough investigation of the petitioner's existing indebtedness, available assets, present net earning capacity, and the status of the various items pledged under the mortgage, decided to grant the petition.

The lease of the Manhattan Railway, which the Interborough had acquired, had not been included as an asset under the mortgage, and this was added by the Commission, so that the bondholders might have the security of the entire earning capacity of the system.

Another modification of the proposed mortgage was the inclusion within its terms of, not merely the existing interest of the petitioner as lessee in the subway railroads, but also all property, real and personal, which might at any time hereafter be acquired as a part of the equipment.

[5] See 5 P.S.C.R., 1st Dist., N. Y., page 188.

[6] Matter of Application of the Delaware and Hudson Company to issue bonds, 1 P.S.C.R., 2nd Dist., N. Y., 242. Decided July 7, 1908.

The effect of the "hereafter acquired" clause would be, in case of foreclosure, to give the purchaser the right immediately to step into the shoes of the lessee as the holder, not merely of the terms created by the leases, but of all property constituting at that time the equipment of the railroads under the provisions of the contracts. The purchaser would thus be in a better position to fulfill the terms of the leases and operate the property. Without this change legal complications might tie up the use of equipment which had been "hereafter acquired," and which was necessary to the operation of the road. This would be detrimental both to the public to be served and to the party (receiver or purchaser) seeking to operate the property.

The inclusion of a "hereafter acquired" clause is, of course, required very generally by investment banking houses in such cases. Hence, the action of the Commission in including it in this case merely brought the mortgage up to the generally accepted standard, but the incident goes to show what could happen without administrative control.

Payment of Premiums and Unamortized Discounts by Refunding Issues Disapproved

An application of the New York Edison Company gives us a good illustration of the result of investigation of refunding issues.[7] The applicant desired to issue stock to the amount of $5,350,000, with which to refund certain bond issues. Regarding one of the issues to be refunded, it was ascertained that the bonds had originally been sold at 80, and that no effort had been made to amortize the discount. In addition, this issue, amounting to $988,000 did not mature until 1940, and if called prior to that date, was subject to redemption at 105. Hence, neither the original 20 per cent discount nor the premium of 5 per cent which must be paid to present holders represented any actual cash investment.

The Commission held that stock should not be issued to pay discounts and premiums upon outstanding bonds, that while it was true that these bonds had been issued prior to the advent of the Commission, yet if the issue had taken place under its approval, the company would have been required, as a matter of course, to amortize the discount during the life of the bonds. Therefore, the Commission felt that both the discount and the premium should be paid by the company out of current income. The face value of the bonds, $988,000, together with the 5 per cent pre-

[7] Matter of Application of the New Yorks Edison Company for Authority to Issue Additional Stock, 2 P.S.C.R., 1st Dist., N. Y., 276. Opinion adopted March 22, 1910.

mium, $49,400, amounted to $1,037,400. Of this amount, the Commission would allow only 80 per cent, or $790,400, leaving $247,000 to be met by the company out of income.

Inasmuch, however, as it appeared that the applicant was urgently in need of funds for extensions and additions, the Commission did decide to allow the issue of the full amount of stock asked for, upon condition that no part of the $247,000 be used to pay off the aforesaid discount or premium.[8]

Refunding Cannot be Used to Obtain a Higher Rate of Return Without Compensating Advantages

The Commissions have sought to prevent abuse of the privilege of refunding, such as, for instance, the issuing of new securities at higher rates than those paid upon existing securities, unless it could be proved that such a change was warranted. This point came up in the Greenwich and Johnsonville Railway Company case.[9] The applicant had outstanding $500,000 of 4 per cent bonds which had sixteen years to run. It desired to retire them immediately with forty-year bonds at "not over 5 per cent." Held, that if the new bonds could also bear 4 per cent interest and be sold to advantage, retirement of existing bonds would not be open to objection, but to retire a 4 per cent bond having sixteen years to run, with a new 5 per cent bond maturing in forty years did not seem proper unless proof could be offered that the applicant's treasury would be saved from loss, and that the interest charges for the sixteen years would not be increased without corresponding increase in the company's assets in property, or in cash to be devoted to construction or improvements. It was suggested that if a 4½ or 5 per cent rate was necessary for new bonds, 500 of them could be held in the Treasury of the company to take up existing bonds upon maturity in 1924. Petition denied.

In July, 1909, the Geneva and Auburn Railway Company applied for authority to issue 5 per cent bonds to the amount of $400,000, with which to retire outstanding 4 per cent bonds to the amount of $450,000. The holders of the outstanding bonds were willing to make the exchange,

[8] In the same connection see Matter of Application of the New York Municipal Railway Corporation for permission to execute a mortgage and issue bonds, 4 P.S.C.R., 1st Dist., N. Y. 105, and especially the dissenting opinion of Commissioner Maltbie. The Orders in this case were entered March 20, 1913.

[9] Matter of Application of the Greenwich and Johnsonville Railway Company for Authority to Issue Bonds, 1 P.S.C.R., 2nd Dist., N. Y. 90. Decided February 18, 1908.

and permission was granted. This exchange made an increase in interest charges of $1,500 per year, but the Commission was convinced that it would be proper to authorize this greater interest rate in view of the fact of the surrender and cancellation of the excess bonds to the amount of $50,000. About four months later the company filed another application asking for authority to issue its 6 per cent cumulative preferred stock to the amount of $50,000, to be issued to the bondholders who had held the $450,000 of bonds.[10] This application was based upon two claims: First, that the bondholders had surrendered old bonds to the amount of $450,000, in exchange for new bonds to the amount of $400,000; second, that these same bondholders had paid to the company $125,000, in cash which the company had used for its own purposes. This second application was denied, the Commission holding that the old bonds had been refunded upon the original order as issued, and that in the eyes of the Commission there were now no outstanding bonds to refund.

Disapproval of Refunding Plan Injurious to Minority Holders

The Central New England Railway Company presented to the Second District Commission a refunding scheme which the latter headed off with little ceremony.[11] The applicant desired consent to execute a mortgage upon its property in the amount of $20,000,000, and to issue bonds under the mortgage to the amount of $12,910,000. The company had outstanding common stock, $4,800,000, preferred stock, $3,750,000; a total of $8,550,000. Of this stock, the New York, New Haven and Hartford Railroad Company owned a total, common and preferred, of $7,826,000. This gave the New Haven practical control of the applicant company which also had outstanding funded and other indebtedness amounting to $12,320,000. Of this indebtedness the New Haven held approximately $10,000,000, and third parties, $2,330,000. A part of this indebtedness consisted of certain general mortgage income bonds amounting to $7,250,000, of which the New Haven owned $6,329,000, and other parties approximately $921,000. These bonds had been outstanding ten years and no interest had ever been paid upon them.

The applicant proposed to issue 4 per cent interest-bearing bonds in the place of the income-bonds owned by the New Haven. The remarkable part of the plan was that under the proposed mortgage other

[10] Matter of Application of the Geneva and Auburn Railway Company for authority to issue stock, 2 P.S.C.R., 2nd Dist., N. Y. 427. Decided May 17, 1910.

[11] Matter of Application of Central New England Railway Company for authority to issue bonds, 2 P.S.C.R., 2nd Dist., N. Y. 205. Decided August 11, 1909.

parties were to have no right to exchange their income-bonds for interest-bearing bonds.

This mortgage indenture was unique in being a tripartite agreement, the parties being the Central New England Railway Company, The New York, New Haven and Hartford Railroad Company, and the New York Trust Company. The last-named party was the trustee. None of the other holders of bonds had a right, without the permission of the New Haven Company, to the benefits of the mortgage. These were, in express terms, reserved to the parties to the instrument.

A part of the outstanding bonds which the applicant sought to refund, had unpaid interest coupons attached to them amounting to some $403,300. Interest upon these coupons from their due-date amounted to $131,400. All of these bonds and attached coupons were owned by the New Haven, and the applicant asked authorization to issue its interest-bearing bonds for the amount of the unpaid coupons, and the interest thereon, to the amount of $534,700.

The proposed mortgage, while drawn ostensibly to refund all the outstanding indebtedness of the applicant, was in reality so drawn that no bonds could be issued by the trustee to refund outstanding bonds unless such outstanding bonds were presented either by the applicant, or by the New Haven Company. Since the latter owned an overwhelming majority of the stock of the applicant, the minority bond-holders would be wholly in its power. The amount of bonds owned by minority holders, and which, under the proposed mortgage, could not be refunded as of right, amounted to $2,331,000.

Concerning the bond-interest represented by the unpaid coupons, the Commission cited the case of Bailey vs. County of Buchanan, 115, N. Y., 301, to the following effect:

past due coupons payable to bearer, even when detached from the bonds, until negotiated or used in some way serve no independent purpose, but while they are in the hands of the holders of the bonds they remain mere incidents of the bonds and have no greater or other force or effect than a stipulation for the payment of interest contained in the bonds; . . .

As to the interest due upon the coupons themselves, the same decision held that "it is entirely certain that this interest upon interest is not a legal obligation of the applicant."

The Commission held that the conversion of income-bonds into fixed-rate-of-interest bonds, when such income-bonds had never paid any return because of the inability of the company to earn it, was unreasonable. For, unless there should be a great change in the earning

capacity of the company, the only result, it was held, would be to throw it into the hands of receivers; besides, third persons owning these bonds to the extent of $900,000, were to have the benefit only of the income provision. The application was denied in toto, but it serves as an instance of what might happen in the absence of administrative regulation.

Bond Premium Charged to Capital

About a year later the applicant again applied for approval of a mortgage, this time to the amount of $25,000,000, but in a form to meet the requirements of the Commission in almost every respect.[12]

The company proposed to reduce $1,250,000 of first mortgage bonds not yet matured, but which could be called at 105, the premium amounting to $62,500. The Commission in this regard held that the benefits to be derived from the general refunding scheme were so great as to justify the 5 per cent premium. This is worthy of note, as bond premium for redemption is not usually regarded as properly chargeable to capital.

During the interval, the financial condition of the company had so greatly improved that it was able to pay 5 per cent interest upon its income bonds. As there was every reason to believe that the financial improvement would continue the Commission felt justified in permitting the refunding of these 5 per cent income-bonds by 4 per cent fixed-interest bonds, thus saving a considerable amount in fixed charges. Accumulated interest, to the amount of $152,000, was required to be paid out of income.

High Redemption Premium-Allowed Under Peculiar Circumstances

Another peculiar instance was involved in the application of the Bronx Gas and Electric Company for approval of an issue of bonds.[13] The applicant's plant was situated in a district of rapidly increasing population, and there was consequently urgent need for a large amount of capital in the near future for improvements and extensions. There was already outstanding a first mortgage, and bonds under it to the amount of $500,000. No more bonds could be issued. A second mortgage, or a consolidated mortgage seemed impracticable, for the reason that bonds issued thereunder could be marketed only at heavy discount. The same condition was held to be true with regard to an increase of the common

[12] Matter of Application of the Central New England Railway Company for authority to issue bonds, 2 P.S.C.R., 2nd Dist., N. Y. 591. Decided October 25, 1910.

[13] Matter of Application of the Bronx Gas and Electric Company for Approval of an Issue of Bonds, 2 P.S.C.R., 1st Dist., N. Y. 150. Opinions adopted November 12, 1909.

or preferred stock. The only practicable plan seemed to be the satisfying of the present mortgage by a refunding of the bonds, and the granting of a new mortgage adequate to the needs of the company ($1,500,000 was planned). As the existing mortgage contained no redemption clause, it was claimed that a sufficient premium must be offered to induce the present holders to voluntarily surrender their bonds. This the latter were willing to do for a ten per cent premium, and the applicant now asked for permission to issue $50,000 of additional bonds as premium.

In view of the great future needs of the company the Commission allowed the amount asked for this purpose, provided that the whole issue was retired. As the proposed new bonds could be paid off after ten years, it was made a further condition of the certificate of approval that a fund be accumulated out of annual payments from earnings which should amount to $50,000, in ten years.

Allowance of Issue of Bonds to Meet Discount on a Refunding Issue

Several instances occurred in which the Commissions felt constrained to depart from the accepted theories of sound finance because of peculiar circumstances. A case in point was the application of the Manhattan Railway Company.[14] This was really a double application. The company desired to issue 4 per cent bonds in the amount of $10,818,000, to provide funds for the retirement of an equal amount of outstanding 6 per cent bonds, and also to issue $894,000 of additional bonds to meet the possible necessity of disposing of the $10,818,000 of 4 per cent bonds at less than par. The Commission took the position that, ordinarily, it would not favor the issuance of bonds to be sold at less than par, and that any deficiency due to discount on the sale of bonds should be treated as an operating expense to be met from income, rather than by the sale of long-term bonds, as here suggested, and which would swell the capitalization of the company. It seems that a provision of the existing mortgage under which the proposed bonds were to be issued, provided for the certification of bonds by the trustee for extensions of line to an amount not to exceed $600,000, per mile of double track. Double track extensions to the extent of 1.49 miles had been made for which no bonds had ever been certified. This would allow said trustees to certify additional bonds to the amount asked for, namely $894,000. Further, it appeared that the applicant operated none of its lines, but had leased them all to the Interborough Rapid Transit Company, which paid the applicant merely a

[14] Matter of Application of the Manhattan Railway Company for leave to issue bonds, 1 P.S.C.R., 1st Dist., N. Y. 205. Order adopted June 12, 1908.

nominal rental, in addition to 7 per cent annual dividends to the stockholders of the applicant. Hence, the latter could not utilize earnings from operation to make up a discount in the sale of bonds, or incur a floating debt for that purpose, as an operating company might do. On the other hand, it did not seem probable that the $10,818,000, of 4 per cent bonds could be sold at par. The Commission held that, in view of the peculiar cicumstances, the additional issue was reasonably necessary for the discharge or refunding of the aforesaid $10,818,000, of 6 per cent bonds, and the order was granted subject to three conditions as follows: (1) That only so many additional bonds should be sold as were necessary for the purpose stated; (2) that the bonds issued for refunding should be offered for sale at a public letting before being issued and sold privately; (3) that a strict account should be kept of the proceeds received and the disposition of the same, subject to audit by the Commission.

Refunding Obligations Assumed Prior to the Taking Effect of the Public Service Commissions Law are Within the Jurisdiction of the Commissions

Another mooted question was the jurisdiction of the Commissions with regard to the refunding of obligations assumed prior to the taking effect of the Public Service Commissions Law, or to agreements of conversion entered into prior to that date.

The Brooklyn Union Gas Company had, in 1904, sold at par $3,000,000 of 6 per cent debentures which by their terms were convertible into capital stock of the company after three years, par for par. It had at the same time increased its authorized capital-stock to provide for such conversion. It now applied for leave to consummate such conversion, or, if the debenture-holders did not desire to avail themselves of the option, to use the proceeds of the sale of the stock to pay them off.[15] This was considered to be a lawful refunding within the provision of the Public Service Commissions Law and the application was approved upon condition that the stock be used only for the purpose stated.

The applicant suggested, however, that inasmuch as contract rights and the obligation to issue this stock had become fixed prior to the enactment of the Public Service Commissions Law, the necessary stock could be issued without the approval of the Commission. Counsel to the Commission held that it was not to be thought that the Legislature deemed it in the public interest that parties to such pre-existing contracts should

[15] Matter of Application of the Brooklyn Union Gas Company, 1 P.S.C.R., 1st Dist., N. Y. 273. Opinion adopted July 17, 1908.

assume to themselves authority to decide upon their rights and privileges pursuant thereto; that such contracts and such acts as tended to fix definitely the rights and obligations of the parties should be submitted to the Commission and its authority obtained for the issue of the stock in accordance with the contract and the law, since it was to be assumed to be the duty of the Commission to see that the rights of security holders were secured to them, and that the rights of the company and the public were protected.

Where the same contention was made in the Second District, a similar position was taken.[16]

Permission Granted to Release, Under a Refunding Issue, Property Pledged Under the Original Issue

In a refunding application of The Delaware and Hudson Railroad Company, it was proposed, in refunding certain obligations, to release a part of the property pledged. Application was made for a first and refunding mortgage upon applicant's railroad property alone, and permission was asked thereunder for the setting aside of new bonds for the retirement of $5,000,000 of 7 per cent bonds which would mature in a few years. It appeared that the mortgage underlying these bonds included, as security, the company's railroad property in Pennsylvania, and also certain coal lands there situated, and which were the private property of the corporation, while the proposed mortgage was based upon all the railroad property of the company, but did not include the coal lands. The result would be to release the private property aforesaid from the incumbrance and shift it wholly to the company's property which was devoted to public use.

The evidence offered showed that the capital acquired through the original bond issue had been applied to the acquisition and improvement of certain railway properties in New York and Pennsylvania. These were now parts of the applicant's main system. It also appeared that none of the proceeds had been used upon said coal lands, although they had been pledged as security under the mortgage. It was therefore held that this outstanding issue of bonds constituted a debt with which the railway alone might be fairly charged.

As evidence, however, of the Commission's determination to keep a strict hold upon the use of the bonds, a provision was inserted in the

[16] Matter of Application of the Delaware and Hudson Company for Authority to issue bonds, 1 P.S.C.R., 2nd Dist., N. Y. 392. Decided December 7, 1908. See pages 406 and 407.

proposed mortgage to the effect that, when any of the bonds set aside for the retirement of underlying bonds were found to be unnecessary for that purpose because such underlying bonds had been obtained by the applicant through the use of funds otherwise derived, such bonds under the new mortgage should be subject to issue only for future acquisition of property, construction, improvements and extensions. The Commission further emphasized the fact that, even in that case, such an issue could be effected only upon special application to and authority granted by the Commission.

CHAPTER XIV

Reorganization

Reorganization is generally brought about by a default of interest upon bonds. This results in foreclosure of the mortgage and forced sale of the property. It involves a change of ownership, in name, at least. Legally, a new corporation is brought into being. Under the Stock Corporation Law of the State of New York, the new company had authority to issue securities to the full amount of those outstanding under the old company, plus any new money advanced under the terms of the reorganization plan.

Reorganization Practice Since 1850

The General Railroad Law of 1850 had authorized railroad companies to mortgage their property and franchises, and, naturally, a purchaser on foreclosure would have the right to maintain and operate the railroad. Chapter 282, of the Laws of 1854, authorized such a person to form a new corporation for that purpose. In the year preceding, a statute had been passed (Laws of 1853, Chap. 502) which provided that in the case of a foreclosure sale of a railroad or plankroad, any stockholder of the defunct company could at any time within six months pay to the purchaser a share of the price for which the property sold, equal to the proportion his stock in the old company had been to the whole amount of capital stock. He thereupon became vested with the same interest in the property that he had had formerly. This remained the law, practically, till 1874. During this period a large number of railroad foreclosures occurred all over the country, and it had become a common practice, in such cases of reorganization after foreclosure, to allow stockholders and holders of junior securities some interest in the new corporation. The stockholders were often required to contribute fresh capital. This was the easiest source from which to obtain money, as the old stockholders would hope to retrieve some of their original investment. If a property had failed because of gross mismanagement, it was probable that a change to efficient management would gradually place the company's affairs in shape to permit of the recovery of the full investment. Such successful reorganizations have been by no means infrequent. Or, again, a property, such as a railroad, may be ten or fifteen years ahead of its time. This was especially true in the United States during the period mentioned. A railroad in a sparsely populated section might go

bankrupt because of insufficient business, whereas the growth of population and general development might, in the course of ten years, change it into a very lucrative proposition and fully justify (both on the part of original stockholders and on the part of a law which arranged for such a plan) what seemed at the time to be throwing good money after bad.

It would seem then that, in a country susceptible of largely increased development, a reorganization law which provided for the issue of securities by the new company upon the basis of the outstanding securities of the old company, and which allowed old stockholders, who, ordinarily, would have had their claims wiped out, to retain their interest upon the payment of additional funds, had a sound basis. In a large number of cases the end justified the means.

To apply such a theory, however, to a property which had been scuttled fore and aft, and whose business had already reached the height of its possibilities, due to the full development of the community served and a marked increase of competition, was a different matter. The Third Avenue Railroad, in New York City, as a case in point, had practically reached its possibilities in the way of earnings, by 1906, and was being subjected to serious and increasing competition by the underground transit system. It had been leased to the Metropolitan Street Railway Company, and under this lease had been saddled with a heavy issue of bonds (approximately $37,000,000). The proceeds of about $13,000,000 of these bonds could not satisfactorily be accounted for.

In the hearings upon the second reorganization plan of the Third Avenue Company, a statement of the secretary of the defunct company, relative to the management of the company's affairs during the period while it was leased to the Metropolitan Street Railway Company, was offered in evidence.[1] This statement was to the following effect:

> . . . large sums of money were raised by the Metropolitan Street Railway Company which were not expended upon property of this defendant (Third Avenue Railroad Company) or in any business or concern of this defendant, but were wrongfully expended by said Metropolitan Street Railway Company for its separate purposes.

Under such circumstances, asking the old stockholders to contribute additional funds actually is throwing good money after bad, as instanced by the stock of the reorganized company in this case, (Third Avenue Railway Company) which sold as low as $17 per share in the winter of

[1] Matter of Application of Bondholder's Committee for Approval of the issue of Bonds and Stock, 2 P.S.C.R., 1st Dist., N. Y. 347. Opinion adopted July 29, 1910. See top page 385.

1916-1917, although $45 per share of new money was paid in upon reorganization in 1912.

Such issues of new securities upon the basis of the old are a menace both to the investing and to the travelling public. The former are invited to purchase bonds upon which interest cannot be met, and, as a result, the consuming public is subjected to the impairment of service in facilities involved in frequent receiverships. It would seem, therefore, that a law whose liberal provisions may be justifiable and distinctly helpful to the business interests of a community, state, or nation, in its formative period, may cause confusion and embarrassment to all interests concerned when the period of full development has been reached, because the element of elasticity, which was the only foundation for such a plan has disappeared.

Apparently, the value of the property is then the only basis for a sound and enduring reorganization. Money lost in the original venture must be faced just as any other loss.

Reorganization Under the Public Service Commissions Law

The Public Service Commissions Law introduced a marked change of policy with regard to utility capitalization, and in such a period of adjustment between new and old regimes losses are inevitable. The day of judgment may be deferred, but cannot be sidestepped, and the sooner it is met the better for all concerned.

The Public Service Commissions Law, as originally enacted, was subsequently found to be defective in the power which it conferred upon the Commissions in dealing with reorganizations. This was due to the fact that it failed to embody specific powers in the treatment of reorganizations, whereas the existing Stock Corporations Law, in Sections 9 and 10, did bestow upon corporations and groups of individuals specific powers for the reorganization of corporations. It is true that the spirit of the Public Service Commissions Law supported the theory that securities should not be authorized by the Commissions in excess of the value of the corporate property, and no doubt the framers of that law felt that this general rule would apply to corporations in process of reorganization just as well as to new ones. The courts, however, when they had an opportunity to pass upon the question, took the position that specific provisions of an existing law were not repealed, by implication, by a subsequent general law. It was asserted that the usage of the courts frowned upon such tendencies.

During the period preceding a judicial interpretation of this phase of the Public Service Commissions Law both Commissions proceeded upon the assumption that securities issued by a reorganized company should not exceed the value of the property at the time of the reorganization. This might be called the first period in the handling of reorganization cases, during which the Third Avenue case[2] in the First District, the Port Jervis case,[3] and the Genesee Light & Power case[4] in the Second District were disposed of.

The decision in the Third Avenue case was challenged in the courts and in a decision handed down by the New York Court of Appeals upon November 21, 1911, the ruling of the First District Commission was reversed.[5] This decision left the matter of reorganization of a corporation practically as it was, prior to the enactment of the Public Service Commissions Law, the Commissions having merely ministerial powers in seeing that reorganizations were carried out according to the provisions of the existing reorganization statute. This might be called the second period, and under it came the reapplication of the Third Avenue case[6] and the Metropolitan case[7] in the First District, and the case of the Adirondack Power Company[8] in the Second District.

During this period companies in process of reorganization were able to defy the Commissions by putting out securities to the full amount of the outstanding issues of the old companies, so that the Commissions were compelled to act in a purely ministerial capacity.

[2] Matter of Application of the Bondholder's Committee of the Third Avenue Railroad Company for Approval of an Issue of Bonds and Stock, 2 P.S.C.R., 1st Dist., N. Y. 94. Opinion adopted September 29, 1909. (First Reorganization Plan.) See also Matter of Application of Bondholder's Committee of Third Avenue Railroad Company, 2 P.S.C.R., 1st Dist., N. Y. 347. Opinion adopted July 29, 1910. (Second Reorganization Plan.)

[3] Matter of Petitions of the Port Jervis Light and Power Company and the Port Jervis Traction Company for Approval of the issue of bonds and stock, 2 P.S.C.R., 2nd Dist., N. Y. 315. Decided January 6, 1910.

[4] Matter of Application of the Genesee Light and Power Company for Authority to issue capital stock, 2 P.S.C.R., 2nd Dist., N. Y. 443. Decided May 17, 1910.

[5] 203 N. Y. 299.

[6] Matter of Application of the Bondholder's Committee of the Third Avenue Railroad Company for Approval of an Issue of Stock, 3 P.S.C.R., 1st Dist., N. Y. 21. Opinions adopted January 17, 1912.

[7] Matter of the Plan for Reorganization of the Metropolitan Street Railway Company and the proposed issue of securities in accordance therewith, 3 P.S.C.R., 1st Dist., N. Y. 113. Opinion adopted February 27, 1912.

[8] Matter of Application of the Adirondack Electric Power Corporation to issue stock and bonds, 3 P.S.C.R., 2nd Dist., N. Y. 242. Decided February 19, 1912.

In 1912 an amendment was added to the Public Service Commissions Law giving the Commissions the needed specific powers to base approval of security issues of reorganized corporations upon the value of the property. The time extending from the adoption of this amendment to the present might be called the third period. In the Second District one important reorganization case, that of the West Chester Street Railway Company,[9] was handled in accordance with the powers conferred by the 1912 amendment. In the First District there was the case of the Mid-Crosstown Railway Company,[10] and a little later came the Dry Dock case, which is of peculiar significance.

The Dry Dock case,[11] while it is ostensibly a refunding case, seems to constitute an evasion of the amended reorganization section of the Public Service Commissions Law. In fact, if we regard the adoption of the 1912 amendment to the Public Service Commissions Law as opening a third period, in which the Commissions felt assured that they actually had the powers, in dealing with companies in process of reorganization, which they thought they had originally, then we may regard the results of the application of the Dry Dock, East Broadway and Battery Railroad for the issue of bonds for refunding outstanding securities, as opening a fourth period. For it would seem that corporations have found a way to circumvent the reorganization amendment of 1912 by getting the practical results of a reorganization, as permitted prior to that amendment, through a technical "refunding" procedure.

[9] Matter of Application of the West Chester Street Railroad Company for Authority to Issue Stock, 3 P.S.C.R., 2nd Dist., N. Y. 286. Decided April 24, 1912.

[10] Matter of Petition of the Mid-Crosstown Railway Company, Inc., 3 P.S.C.R., 1st Dist., N. Y. 416. Opinion adopted November 1, 1912.

[11] Matter of Application of the Dry Dock East Broadway and Battery Railroad Company to Issue Bonds, 5 P.S.C.R., 1st Dist., N. Y. 141. Opinion filed March 3, 1914.

CHAPTER XV

Reorganization Under the Public Service Commission Law—First Period

The Port Jervis case was ideal in many ways.[1] It came during the early period when the Commissions thought they possessed the necessary powers. The (Second District) Commission endeavored to base its authorization of the security issues in this case upon the value of the property, and the applicant coöperated in the same spirit. As a result, a considerable amount of overcapitalization in the old securities was eliminated, and the reorganized corporations were started upon a sound financial basis.

The predecessor company had furnished gas, electricity, and traction service. The gas and electrical business had shown some profit over operating expenses, but the street railway had not. Because of overcapitalization the company had not been able to meet the requirements of the Commission in the way of improved service and under foreclosure sale by the bondholders had been bought in for them. Two new companies had been organized, and these now applied to the Commission for approval of their plan of capitalization.

The Port Jervis Light and Power Company, one of the newly organized corporations, presented a petition respecting its capitalization as a successor corporation to the Port Jervis Electric Light, Power, Gas and Railroad Company in the taking over and operating of the gas and electric properties, while the Port Jervis Traction Company, the second of the new companies, applied for capitalization as successor in the taking over and operating of the street railway property.

At the time of the foreclosure sale the outstanding capitalization of the old company was made up of:

Capital stock	$450,000.
Bonds	285,000.
Total	$735,000.

At the sale the properties had been bought in for the bondholders, the gas and electric properties for $225,000, and the street railroad property for $25,000.

[1] Matters of Petitions of the Port Jervis Light and Power Company and of the Port Jervis Traction Company, 2 P.S.C.R., 2nd Dist., N. Y. 315. Decided January 6, 1910.

The reorganization plan submitted by the applicants provided as follows: That the capital stock of the old company, amounting to $450,000, should be wiped out; that the bonds of the old company, $285,000 in all, should be exchanged for the capital stock of the new companies according to the amount of capital stock which the Commission should see fit to approve; that, in addition, bonds of the new company should be issued to meet the expenses of reorganization, and the cost of necessary improvements and extensions to the properties. The combined capital asked for by the two new companies amounted to $517,000, a reduction of $218,000, or practically 30 per cent from the capitalization of the old company.

The traction property had been so unsuccessful that its credit was very low, and bonds based solely upon this property could have been sold only at a great sacrifice. Hence, the Light and Power Company suggested the plan of taking them over and then issuing an additional amount of bonds of its own. This feature met with the approval of the Commission.

Fair Value of Property Basis Accepted by the Applicant Corporation

The applicant companies themselves conceded that the capital to be issued should be based upon the present value of the properties and the added cost of necessary improvements and additions, plus reorganization expenses.

The Commission, after investigation, decided that securities should be authorized for a total capitalization of $390,000, a reduction of $345,000, or 47 per cent from the capitalization of the old company, and a reduction of $127,000, or practically 25 per cent from that asked for by the applicant companies.

The feature of the plan by which the stock of the two companies was to be paid to the bondholders, who were the present owners of the properties, was approved. The amount of stock asked for by the applicant, $317,000, was reduced by the Commission to $137,500, whereas the bonds of the old company for which the stock was to be exchanged, amounted to $288,000.

However, as stock is elastic in value, so long as a bondholder got his proportionate share of all the stock, the amount, in itself, would make no difference, as he would have his share in the ownership of the property, whether he got two shares or one. Of course, if subsequently there was issued additional stock in which he could not acquire a proportionate amount, this would fail to hold true.

The application of the Genesee Light and Power Company[2] was marked, upon the part of the corporation, by a spirit of aggressive challenge of the Commission's powers. The applicant seemed unwilling to recognize the passing of the old regime of unbridled license in utility financing.

Application was made for authorization to issue capital stock to the amount of $250,000, consisting of $150,000, common and $100,000, preferred stock, as consideration for the conveyance to the corporation of the property formerly owned by the Genesee County Electric Light, Power and Gas Company. The latter had been an operating company, but had been unable to meet its obligations, and the property and rights of the company had been sold at judicial sale. At this sale trustees for a bondholders' association of a Maine corporation, known as the Genesee Niagara Power Company, bought the property for $101,500, which sum paid the debts of the old company and left the property free. The trustees for the bondholders' association now owned the property and had associated themselves together under section 9 and 10 of the Stock Corporation Law as a corporation, and asked for capital, as above, for the transfer by the trustees to the corporation of the aforesaid property.

The old company had been a typical promoter's scheme, in which the promoters had secured a power contract from the Niagara, Lockport and Ontario Power Company, and had sold the same to a company of their own creation for $100,000. In December, 1905, the promoters had applied to the Commission of Gas and Electricity for leave to issue $200,000 of stock and $100,000 of bonds for which the company was to actually receive in value in the neighborhood of $75,000 to $80,000. The application was denied, but the promoters were not discouraged. They immediately organized a holding corporation under the laws of the State of Maine, called the Genesee Niagara Power Company the trustees of whose bondholders' association had bought in the properties under discussion. As a result of various contracts and agreements subsequently entered into between the Maine holding corporation and the New York Company, the latter had agreed to issue stocks and bonds to a total amount of $400,000; and it had further agreed, until such time as it could issue stock and bonds to that amount, that it would pay to the Maine corporation the sum of $20,000 annually, that is, 5 per cent upon $400,000, in return for an assignment of a power contract and $92,000 cash, as alleged.

[2] Matter of Application of the Genesee Light and Power Company for Authority to Issue Capital Stock, 2 P.S.C.R., 2nd Dist., N. Y. 443. Decided May 17, 1910.

In 1908, a receiver was appointed. The company's assets, as shown in its report to the Commission for that year, totalled $280,000, approximately. This included $100,000 paid for the power contract, leaving $180,000 for actual assets. There seemed to have been no increase in assets since that time, although in the petition it was claimed they were worth $567,700.

The question was whether upon reorganization the new corporation could issue such amount of stock as it might elect and whether such amount was within the control of the Commission. The position of the applicant was stated to the following effect:

there is no power in the Commission to examine into this reorganization further than to see that the plan of reorganization is lawful and that the trustees under the plan are properly executing their trust. That when this is ascertained its powers are not judicial but ministerial, and it is its duty to approve the issue of stock as set out in the agreement.

This was the identical position assumed by the applicant in the Third Avenue case and which the Commissions were subsequently forced to assume by the decision of the Court of Appeals in that case.

The Commission contended that it was not logical to assume that the Legislature intended that a reorganized corporation should exclusively determine the amount of its capitalization while in the case of all other corporations subject to the supervision of the Commissions such capitalization must be authorized by the Commissions; that it did seem logical that corporations which found it necessary to reorganize were the very ones most likely to be suffering from over-capitalization, and that, if the Public Service Commissions were to realize the expectations entertained for them, power over reorganizations was essential.

As to the amount of stock which the applicant should be authorized to issue, the Commission held that stock should be issued in an amount equal to the fair and reasonable value of the property and no more.

Allowance for Value of Power Contract Based Upon Reasonable Profits Upon Capital Invested

With regard to the item of $100,000, for the power contract with the Niagara, Lockport and Ontario Power Company, proof was lacking to show that it was worth any such sum. No special advantages entered into it. Whatever of value there was in the contract, it was held, depended entirely upon the price to be paid for the power and the price or which it could be sold. There should be allowed, and the applicant was entitled to make, such difference between these two sums as would

pay the operating expenses, take care of the depreciation of its plant, and afford a reasonable return upon the amount invested in its plant. Generally speaking, if the difference between the buying and selling price included anything more than this, such excess was unreasonable and should be cut off from the selling price, and therefore the contract had no value which was dependent upon this purpose. Its value, it appeared to the Commission, rested upon the reasonable profits which might be made in the business upon the money actually invested.

No Allowance Permitted for Engineering Expense Upon Original Construction

The various important items alleged to have been purchased at the judicial sale were discussed. Many of the intangibles were thrown out, such, for instance, as an item of $8,778 for engineering expenses upon original construction. In passing upon this point, the Commission held that prior to the original construction, estimates had been made as to the engineering expenses which would enter into the construction, and that allowance therefor had already been made in ordinary cases of capitalization. This, however, was not such a case, as the property had already been constructed, and had been purchased as complete.

Therefore, any estimate of its value must necessarily include all of the elements of its cost, including engineering expense as much as expense for copper or brick. There was also an item for $20,000, for "marketing securities of Maine corporation," and another item for alleged value of franchises. Such were, of course, disallowed.

Fair Value of Property Basis Applied Over Corporations Protest

The Commission concluded that a corporation organized pursuant to section 9 of the Stock Corporation Law, if it belonged to one of the classes named in the Public Service Commissions Law, could, with the authorization of the Commission, issue stock and bonds for the acquisition of the property of the corporation which was sold upon judicial sale. The basis upon which such securities could be issued was stated as follows:

> that such stock and bonds may be authorized to the amount of the fair value of the property sold upon such judicial sale, and that such property must be either tangibles or such intangibles as constitute a right to demand and receive or otherwise enjoy the possession of tangible property.

Capital stock was finally authorized for what was considered the fair value of the property to be taken over. Some $166,000, it appeared, had

actually been expended from all sources, including expenditures by the receiver.

The Commission, in closing its discussion of the matter, refers to the issue of stock in direct violation of the order of the Commission of Gas and Electricity denying authority for such a purpose. It further points out that the existence of the Maine corporation was part of a scheme to defeat the New York State Law; that the agreement to pay the Maine corporation $20,000, annually, was simply a device to cheat the law; and that every holder of the Maine securities must have been cognizant that such was the case. In this connection, the Commission observed that "these facts, if properly weighed, might lead to results not pleasant to the reorganized corporation." This threat and the knowledge that it was well-founded may have accounted for the fact that the decision of the Commission was not appealed to the Courts, as the Third Avenue decision was, although the power of the Commissions to scale down proposed securities to the value of the property was just as hotly contested as in the latter case.

The Third Avenue Case

The first reorganization plan of the bondholders of the Third Avenue Railroad Company was presented in July, 1909.[8] It was contended by the applicant, the bondholders' committee of the old company, the Third Avenue Railroad Company, that the proposed new company, the Third Avenue Railway Company, had a right to "reorganize upon the basis of the old securities," and that the functions of the Commission were purely ministerial.

The First District Commission took the position that the Legislature, in constituting the Commission an administrative body and giving it power to approve or disapprove the issuance of securities, did not contemplate that its action in any class of cases should be simply ministerial, but intended that it should have the power to determine the details of the reorganization scheme and the amount of stock and bonds which should be issued in order to carry it out.

It was proposed by the applicant that the new company should issue over $68,000,000 of new securities, making an increase in capitalization of nearly $15,000,000, of which not more than $6,500,000 would go to improve the tangible property. No inventory, even partial, and no appraisal or even estimate as to the actual value of the property upon

[8] Matter of Application of the Bondholder's Committee of the Third Avenue Railroad Company, 2 P.S.C.R., 1st Dist., N. Y. 94. Opinion adopted September 29, 1909.

which such securities were to be issued was submitted. The Commission felt that in the absence of any such data it was "wholly unable to reach the conclusion that a company unable to pay fixed charges and dividends upon $58,560,000 of securities should be superseded by one having $73,516,800 of stocks and bonds."[4] Many of the notes of subsidiary companies for large amounts, held as assets, were worthless, and everything seemed to indicate that even the present securities were far from representing proper expenditures for capital purposes.

Earning Power as a Basis for Security Issues

The applicant company's case, from a financial point of view, seemed to rest upon its optimistic estimate of the net income of the system. The receiver claimed that the net earnings of the lines owned or operated would not be less than $1,500,000, after paying interest on over $9,000,000 of underlying bonds. The estimate seemed unwarranted, judging by the data available, but even if it were accepted, no allowance had been made for franchise taxes and very little for depreciation. A reasonable allowance for these two items made estimated net earnings seem far from sufficient to meet bond-interest.

The applicant laid great stress upon the increase in earnings from year to year, but the Commission felt that such estimates were too imaginary and uncertain, and that it would be inviting disaster and a repetition of the receivership to base large amounts of securities upon them.

The Commission endeavored to show how the proposed plan would work out upon the estimates submitted and how far short results would come of justifying such issues. The receiver estimated the probable net income of the reorganized company at $1,200,000, although due allowance for franchise taxes and depreciation would have made $900,000 more probable. The annual interest upon the proposed refunding bonds to the amount of $32,516,800, would be $660,000, leaving $540,000, with which to pay interest at 5 per cent upon the proposed $32,000,000 of adjustment bonds, and any dividends upon the stock. The interest on these bonds alone would call for $1,600,000. The holders of the adjustment bonds, under the proposed plan, were to have no rights of foreclosure. Upon this basis the return to these bondholders would be less than 1.7 per cent on the basis of the receiver's estimate, and less than .8 per cent upon the corrected estimate. The holders of the common stock would

[4] An issue of $5,000,000 of first mortgage bonds was to remain. This made $68,500,000 of new securities and a total under the reorganization plan, of $73,500,000.

get nothing, although called upon to pay an assessment of $25 per share upon their holdings.

The Commission concluded that cumulative five per cent interest upon the $32,000,000, of adjustment bonds would not be earned for a long time; that no dividend upon the $20,000,000, of stock would be earned for a much longer period, and that, therefore, there was no justification for authorizing the issue of such securities.

Proposed Use of Bond Proceeds for Purposes Not Proper Objects of Capitalization

Of the proceeds of the proposed securities, approximately fifteen million dollars, face-value, the excess over the amount required to refund the old securities, were to be devoted to objects most of which would not add in any way to the value of the property and which, ordinarily, could not be regarded as proper objects of capitalization. Nearly a million dollars was to be used to take up outstanding obligations of subsidiary companies, another million to provide extensions, another million for renewal of tracks, another to pay franchise taxes overdue, another for reorganization expenses, a million and a half for subsidiary companies, two and one half millions for the syndicate for services in disposing of securities, etc., three millions to pay principal and interest of receivers' certificates, and three millions more for unpaid interest on bonds.

It was held that while, under the circumstances, it might be proper to issue short-term notes for such expenses, the capitalization by long-term bonds or common stock of such items as repairs, renewals, taxes, unpaid interest, reorganization expenses, and the like, amounted practically to the capitalization of liabilities rather than assets and was extremely objectionable from the point of view of sound finance.

Interest of the Public Vital as to Amount of Securities Issued by a Reorganized Company

The Commission felt that it should bear in mind the fact that many people believe that its approval of securities is a certificate of character and that when the Commission approves an issue of securities it is good evidence that there is genuine property back of them, and that a reasonable probability exists that interest and dividends will be paid. Certainly, it was held, the public did not believe that the Commission would allow securities to be issued which were represented by no property and upon which there was no probability of a return.

The receiver of the company, in his testimony, took the position that it made no difference to the investing public or to the general public

how many stocks or bonds were issued by a reorganized company; that the main function of the Commission was to enforce adequate facilities and accommodations to the public to be served.

The Commission held that the enactment of the Public Service Commissions Law served notice upon all who held such views that the public was rightfully interested and would thereafter have a say in the issuance of securities, that an end might be made to the unsavory practices of the past.

The attitude suggested by the applicant might be logical as far as stock was concerned, if the stock remained in the hands of the first parties. But to maintain that an excessive amount of ordinary bonds, that is, bonds with rights of foreclosure, can make no difference to the public, is preposterous, and such a statement would seem to reflect either upon a man's intelligence or his sincerity. Such a condition would result in constantly recurring receiverships, or, at least, in neglect of depreciation and skimping of service, in an effort to keep out of receivers' hands.

On the other hand, the issue of bonds without foreclosure rights, such as the income bonds, which formed a large part of the proposed issue in this case, amounts practically to selling preferred stock to the public under the name of bonds. Bonds without foreclosure rights would hardly seem to be bonds at all. The public may buy them for a while under a misconception and be deceived thereby, but a realization of the true nature of such securities would soon place them in the same category and subject to the same valuation as stock, the only difference being that they would have a preferred claim as to assets, but with a limitation as to return.[5]

Furnishing of Adequate Facilities by a Public Utility Dependant Upon Proper Capitalization

The receiver for the Third Avenue Railway company had contended (as mentioned above), that, since the state had created a body with power to compel the furnishing of adequate facilities to the public, the amount and character of securities were matters with which the public had no concern.

It is, perhaps, true that an important factor in bringing about the passage of the Public Service Commissions Law in New York State in 1907, as far as New York City, at least, was concerned, was the lack of adequate facilities in the way of transportation and the desperation of the

[5] In fact, it was admitted at the hearings that the term "bonds" was used instead of "stock" in order to enable insurance companies to hold them under the law.

consuming public in their continued failure to make the companies respond. But the underlying cause, the real reason for this state of things, was the unbridled over-capitalization of the large street railway companies. This caused them to neglect maintenance in order to meet fixed charges upon watered securities. In other words, the lack of service was a symptom of a disease, the real disease being over-capitalization. It is true that the Commissions are vested with power to compel the companies to furnish adequate facilities, but to try to force the companies to furnish adequate service without attempting to remove the cause which renders them unable to furnish it is like attempting to cure a disease by suppressing the symptoms. The disease would remain, and symptoms would break out in another place, that is, the companies would be thrown into the hands of a receiver. The Legislature can place a law upon the statute books, but it cannot make water run uphill.

If the income of a public utility company is inadequate to meet both bond-interest and expenses of maintenance, one of two things must happen, and all the power of a Commission cannot alter the result: either, the company must skimp the service, or it must go into bankruptcy, provided, of course, that it is not allowed to increase its revenue from the public.

The Commission felt the absurdity of attacking the symptom and not the disease. If the cause were removed the effect could easily be remedied, and the Commission did not propose to be put in the futile position of trying to contravene economic laws. It drew the following conclusions:

(1) Over-capitalization almost invariably tempts managers to give inferior service at higher rates, which vitally affects the travelling public;

(2) No matter how excessive the issues of stock and bonds, the manager feels that he is expected to earn interest and dividends thereon, and inasmuch as every time he is able to increase the rate of profit by a fraction of one per cent he adds to his reputation, he is naturally very strongly tempted to try to squeeze an extra one per cent out of the service or the fares;

(3) If the capitalization were smaller, it would be easier to earn interest and dividends without robbing the service; and

(4) That the Commission is of the opinion that the approval of the present application would strongly tend to produce inferior service and higher fares or fewer transfer privileges.

The application was denied upon the ground that the facts presented did not warrant the conclusion that the capital was reasonably required. The Commission emphasized the fact that the applicants had failed to prove that there were assets or property of sufficient value to justify a

capitalization of $73,000,000 (exact amount $73,516,800), and further pointed out that there were strong indications that the old company was over-capitalized and that the outstanding stock and bonds—$58,560,000—were not represented by actual property.

Third Avenue Case—Second Plan

Several months later a second reorganization plan was presented.[6] This too, while much more moderate than the former, was denied because the amount of capitalization still far exceeded the value of the property.

This plan involved a total capitalization less by $15,600,000, than the former. Twenty-five per cent of the old consolidated bonds were to to be paid off by means of common stock. Stockholders who paid the assessment of $45, increased from $25, were to receive 40 per cent upon their old stock in first refunding bonds, plus $45 in new stock.

The Commission made an even more thorough investigation of the affairs of the applicant, but came to the conclusion that the value of the property was far below even the amount of capitalization proposed in the new plan and that there was little probability that the interest on the bonds could be met fully for some time. Bonds should not be issued, the Commission again insisted, in excess of an amount upon which interest could be assured. The Commission arrived at a valuation of $31,600,000 as compared with $59,916,000 the capitalization asked for.

Court Decisions Upon the Ruling of the Commission in the Third Avenue Case

The case was carried to the courts on a writ of *certiorari*, and the Appellate Division of the Supreme Court for the First Department reversed[7] and set aside the determination of the Commission, and directed it to approve the reorganization plan submitted by the bondholder's committee.

The Commission had held that the reorganization statute had been repealed by the Public Service Commissions Law, not directly, but impliedly. The Court took the position that repeals by implication were not favored by the courts, and that an existing specific law could not be repealed by implication by a subsequent general law; and that unless

[6] Matter of the Application of the Bondholder's Committee of the Third Avenue Railroad Company, for Approval of the Issue of Bonds and Stock, 2 P.S.C.R., 1st Dist., N. Y. 347. Opinion adopted July 29, 1910.

[7] People ex rel. Third Avenue Railway Company v. Public Service Commission, 145 App. Div. (N. Y.) 318. Decided June 9, 1911.

the provisions of the two acts were so inconsistent that they could not exist side by side, a repeal of the earlier one by the later should not be declared.

The Commission appealed to the Court of Appeals, which on November 21, 1911, affirmed the decision of the Appellate Division and directed that the Commission proceed in pursuance of the instructions of that court.[8] The Court of Appeals held, like the Appellate Division of the Supreme Court, that the two statutes were not inconsistent; that the Public Service Commissions Law did not repeal the provisions of the Stock Corporation Law for reorganization purposes, and that, on the other hand, the latter law did not exempt companies in process of reorganization from compliance with Section 55[9] of the Public Service Commissions Law; that the two statutes must be construed together.

It was held that the Commission had not been justified in refusing the application of the bondholder's committee because the value of the property was less than the amount of securities to be issued by the new corporation, inasmuch as the Public Service Commissions Law contained no provision that securities issued should in no instance exceed the value of the property.

The Court of Appeals, while agreeing that as a general rule, under the requirements of the Public Service Commissions Law, securities should not be authorized except where the value of the property is equal to the amount of the securities issued, yet held that "there may be exceptions to that rule." It was pointed out that the provision of the Public Service Commissions Law relating to consolidation or merger, provides that the capital stock of the corporation formed by the merger shall not exceed the capital stock of the corporations consolidated, and any additional sum paid in cash. In this case, therefore, the Court held, the issue of stock was not limited to nor dependent upon the value of the property involved. It was held by the Courts of Appeals that "a readjustment of the interests of the parties (to the reorganization) does not contemplate that the new securities shall necessarily be scaled down to the actual value of the property."

[8] People ex rel. Third Avenue Railway Company et al. v. Public Service Commission, 203 N. Y. 299. Decided November 21, 1911.

[9] Section 55 gave the Commissions power of approval of issues of stock, bonds, and other forms of indebtedness in connection with common carriers, railroad corporations, or street railroad corporations, but made no specific mention of any course to be pursued in reorganization cases. The same was, of course, true of the corresponding sections dealing with gas and electric corporations, and telegraph and telephone corporations, these being the only classes of utilities included within the scope of the law at the time of this decision.

CHAPTER XVI

Reorganization Under the Public Service Commissions Law—Second Period

This decision of the New York Court of Appeals opened what we have styled the second period in reorganization cases, and established that while the Public Service Commissions Law should remain in its original form with regard to reorganizations the Commissions did not have power to base the amount of proposed securities of reorganized companies upon the value of the property.

The bondholder's committee of the defunct Third Avenue Railroad Company, and the representatives of the new Third Avenue Railway Company immediately applied for approval[1] of their "second reorganization plan," in accordance with the mandate of the Court of Appeals to the Commission.

The decision, under the existing condition of the New York statutes, restricted the powers of the Commissions to three functions in such cases. These were to determine: (1) Whether the proposed stocks and bonds were to be issued under and in conformity with the provisions of the Stock Corporation Law, sections 9 and 10; (2) whether the new corporation had been duly vested with the title to the property and franchises of the old corporation; and (3) whether the plan of reorganization was being carried out.

The Commission, as a result of its extended investigations, had found that the proposed capitalization was far in excess of the value of the property, and that the most optimistic estimates of the net income of the property indicated that interest and dividends could not be earned upon the proposed securities. Yet, inasmuch as the court decisions referred to above took no cognizance of these matters and allowed the Commission no discretion in them it was finally compelled to grant approval of the plan submitted. A few months later the Commission authorized the execution and delivery of the two corporate mortgages called for by the reorganization plan, and about the same time an order making certain requirements as to the amortization and depreciation accounts of the new Third Avenue Railway Company.[2]

[1] Matter of Application of the Bondholder's Committee of the Third Avenue Railroad Company for approval of the issue of bonds and stock, 3 P.S.C.R., 1st Dist., N. Y., 21. Opinion adopted January 17, 1912.

[2] Matter of Application of the Bondholder's Committee of the Third Avenue Railroad Company, etc., 3 P.S.C.R., 1st Dist., N. Y., 51. Opinion adopted Feburary 3, 1912.

Requirements for Amortization and Upkeep Stipulated by Commission

The First District Commission at that time held that it had the power to require the amortization of the difference between the fair value of the corporate property and the par value of the securities to be issued. This was to be accomplished by the appropriation and reservation each year, out of annual income, or out of surplus accumulated after the issue of the bonds, of an amount not less than the proportionate amount of such difference. Thus, upon the date of maturity the company, in refunding the bonds then due, would have, as the basis of such refunding, property to an amount equal to the par value of the securities to be refunded. The Commission was now, in obedience to the interpretation of the Court of Appeals, placed in the position of approving securities far in excess of the value of the property. Even if the property was maintained in thorough repair, and adequate amounts for depreciation were set aside, the securities, when matured, would still represent the same excess over value. This excess was estimated at about $26,000,000, and it was planned to build up an amortization fund just as in the case of discount on bonds, and such a provision was placed in the order, but was afterward withdrawn. The same requirement was later made in the Metropolitan case, and was likewise withdrawn. This was because the Commission came to doubt its power to enforce such a provision in the light of the Third Avenue decision.[8] Such amortization of the excess capitalization would, in effect, be another way of regulating the amount of the securities at the time they were issued, which power the court decided the Commission did not have under the law as it then stood. It would be accomplishing indirectly what the court had said the Commission did not have power to do directly. It was estimated that the $55,000,000, approximately, of new securities would net only about $33,000,000, the refunding bonds being figured at 80, the adjustment bonds at 70, and the stock at 30. This made about $25,000,000 to be amortized as bond discount. This, of course, was amply provided for in the uniform system of accounts prescribed by the Commission, and the amortization of this discount would be necessary merely to refund the bonds. The actual value of the property, however, would not be increased any thereby even if the property itself was adequately maintained.

[8] Matter of the Order made by the Commission on February 3, 1912, relative to the Plan of Reorganization of the Third Avenue Railroad Company, 3 P.S.C.R., 1st Dist., N. Y., 453. Opinion adopted December 10, 1912.

In addition, it was held to be necessary, in order to guard against a repetition of the present financial collapse, for the applicant company to reserve, for current maintenance and future replacements to the property, at least 20 per cent of the operating revenue of the company. This rate was held to be neither a maximum nor a minimum, but to be subject to modification upon proof presented to the Commission.

The Order of February 3, 1912, accordingly, provided that, before paying interest on its bonds or dividends on its stock, the applicant should set aside for maintenance, depreciation and renewals, during each of forty-eight years from January 1, 1912, a sum equal to twenty per cent of its gross operating revenue for that particular year. If this amount was not expended for the purposes mentioned during any one year, then, at the end of such year, the unexpended portion thereof should be credited to a separate depreciation fund. It was further provided that the whole or any part of the amount accumulated in such fund might be used from time to time for maintenance, repairs, replacements and renewals, in addition to the annual expenditures for such purposes as required in the mortgages.

It is a difficult matter to distinguish sharply between maintenance and renewals. The replacing of a worn-out brake-shoe is maintenance, while the replacing of a worn-out rail is a renewal. Between these two are many gradations and it was the idea of doing away with the necessity of such endless distinctions that led the Commission to provide for both by a common fund.

Subsequent Disregard of Upkeep Provision by Third Avenue Railway Company

The Third Avenue Railway Company has not seen fit to set aside twenty per cent of gross earnings as outlined above. This was brought out in the hearings upon the company's application for permission to increase fares, which were held by the First District Commission in June, 1917. For the year 1916, the company's gross earnings were $4,065,484, of which 20 per cent would be $813,097. To maintenance of way and structures there was charged $318,277, and to maintenance of equipment $162,368, making a total of $480,645. This would leave $332,452, to be credited to a separate depreciation fund. There was actually set aside approximately $114,000, leaving the sum of $218,000 which should have been set aside. Whether the Commission actually had power to force the Third Avenue Company to set aside the amount stipulated in the order has been an uncertain question. The decision handed down in January, 1918, with regard to the similar provision imposed by the First District Commission upon the New York Railways Company, supported the power of the Commissions to make such an

order. A subsequent decision in the same case, May 1918, by the New York Court of Appeals has made it plain that the Commissions do not have such power.

At about the same time, February, 1912, a bondholder's committee of the bankrupt Metropolitan Street Railway Company, of which the Third Avenue Railroad Company had previously been a subsidiary, submitted[4] a plan of reorganization and petitioned for approval for the execution and delivery of mortgages and the issuance of securities in pursuance thereof.

The new company to be organized was to be known as the New York Railways Company. Investigation showed that the proposed capitalization of the new company exceeded the fair value of the property by at least $16,500,000. The plan was not approved by the Commission, but was carried through regardless of its finding that the proposed capitalization far exceeded the value of the property, and that the estimates of earnings submitted showed that the company would not receive a sufficient amount to pay operating charges, interest on the first mortgage bonds, and five per cent upon the income-bonds. In view, however, of the action of the Court of Appeals in overruling its decision in the Third Avenue case, the Commission felt constrained to give its consent to the plan.

In carrying out this plan of reorganization the Commission finally made three orders: (1) On January 24, 1912, authorizing the issue of stocks and bonds; (2) On February 27, 1912, consenting to the execution of the mortgages; (3) On February 27, 1912, requiring among other things that the Company reserve 20 per cent of its gross operating revenues month by month to provide for maintenance and depreciation of its properties during the month. The last order as to the provision mentioned was confirmed on rehearing by the Commission. To review this last order, which was practically identical with the requirement made in connection with the Third Avenue Railway Company, and which has just been discussed, the New York Railways Company sued out a writ of *certiorari*, which was argued at the Appellate Division of the Supreme Court for the First Department, on December 12, 1917, and upon which the Court handed down a decision on January 18, 1918.[5]

[4] Matter of the Plan for Reorganization of the Metropolitan Street Railway Company and the proposed issue of securities in accordance therewith, 3 P.S.C.R., 1st Dist., N. Y., 113. Opinion adopted February 27, 1912.

[5] People ex rel. New York Railways Company v. Public Service Commission, 181 App. Div. N. Y., 338. Decided January 18, 1918.

This decision sustained the action of the Commission in thus requiring the New York Railways Company to set aside monthly 20 per cent of its gross operating revenue into a fund for maintenance and depreciation, upon the ground that the facts showed that since the making of the original order, during which time the company had set aside the 20 per cent as required, 16⅞ per cent had been necessary to provide for maintenance, leaving 3⅛ per cent to be accumulated into a depreciation fund; that, therefore, the 20 per cent was a reasonable amount for the purposes specified. Further it was held that depreciation reserves were properly 'operating expenses,' and that the accumulation of such a fund was absolutely necessary to meet future replacements due to depreciation and obsolescence, as the Commission had no authority to permit the issuance of securities to meet such needs. Hence, the lack of such a fund would precipitate another reorganization with its attendant impairment of securities and of service to the travelling public. Therefore, if the Commission lacked the power to compel the setting aside of adequate depreciation funds it would subsequently find itself in the position of being powerless to carry out its two main functions, the providing of protection for the travelling and investing public. Such a conclusion, the Court held, was untenable, both in view of the settled rules of statutory interpretation giving 'implied' powers to make effective powers explicitly given, and in view of the enabling clause contained in section 4 of the Public Service Commissions Law.

The New York Railways Company immediately carried its case to the New York Court of Appeals, and about four months later, May 1918, the latter handed down a decision which reversed the Court at the Appellate Division, and fixed definitely the status of the Commissions as regards their power to compel the setting aside of funds for depreciation.[6] It was stated to be the opinion of the court "that the assertion of authority under review here is outside of and beyond the statute." The Court stated that where power was claimed under the Public Service Commissions Law, it "should have its basis in the language of the statute, or should be necessarily implied therefrom."

This decision was based upon a 'strict' construction, as compared with the liberal construction of 'implied powers' of the Court at the Appellate Division, in connection with the same case.

Apparently, the directors of the New York Railways Company will now be at liberty to deplete the depreciation fund of the company to pay

[6] People ex rel. New York Railways Company et al v. Public Service Commission, 223 N. Y., 373. Decided May 14, 1918.

interest upon the large amount of income bonds which are outstanding. This would, of course, apply equally to the Third Avenue Railway Company.[7]

The accrued amortization fund, as of June 30, 1917, above the amount actually used for depreciation amounted to $3,127,250, which is equal to about 10.20 per cent on $30,626,977 adjustment bonds outstanding.

While the interest on the income bonds is non-cumulative, bondholders and their attorneys hold that they are entitled to a distribution of this fund under the court's decision.

The New York Railways Company has not paid interest on its adjustment income bonds since the period of the first six months of 1916.

The Third Avenue Railway Company has accumulated a reserve fund, which, as of June 30, 1917, stood at $11,385,776. In addition to this amount, the directors subsequently set aside $494,386, special reserve out of earnings for the six months ending December 31, 1917.

Interest on Third Avenue adjustment income mortgage 5s is cumulative and there is now 3¾ per cent back interest due, (May 1918). These bonds are secured by a mortgage which is subject to prior liens. A recent appraisal of the property claimed to show that it had a value considerably in excess of all outstanding bonds.

During this second period an important reorganization case came up in the Second District, that of the Adirondack Power Company.[8] The

[7] In connection with this decision, it is interesting to recall comment made by the company (The New York Railways Company) on the subject in its report for the six months ending June 30, 1912, which reads as follows

"The Public Service Commission has issued an order whereby the company is required to set aside annually an amortization fund of $108,000, for the purpose of making up what the commission alleges to be the difference between the value of property and the total capitalization of this company.

"On the other hand, an appraisal of cost of reproduction of the property new as of October 1, 1910, made by the receivers of the Metropolitan Street Railway Company system, showed that the reproduction cost was $20,000,000 in excess of the entire capitalization of the New York Railways Company, including its underlying bonds.

"It is the opinion of counsel, therefore, that this order is illegal, but as the company covenants under its mortgage to comply with all orders of public authorities, it has been found necessary to reserve from net income a six months proportion of this charge, which, of course, will be available for distribution to the income bondholders, should the order be rescinded. An order, likewise thought to be illegal, has been made by the commission, requiring the company to set aside for depreciation a fixed sum equal to 20 per cent of the gross operating revenue.

"The legality of both these orders is now being contested in the courts."

[8] Matter of Application of Adirondack Electric Power Corporation to issue capital 3 P.S.C.R., 2nd Dist., N. Y., 242. Decided February 19, 1912.

applicant company filed a petition pursuant to section 69 of the Public Service Commissions Law, for authorization to issue $12,000,000 of capital stock, $2,500,000 preferred, and $9,500,000 common, and $5,000,000, fifty-year 5 per cent bonds.

The company had been incorporated in December, 1911, pursuant to the provisions of Section 9 of the Stock Corporation Law, as a reorganization of seven domestic corporations of the State of New York, namely, the Hudson River Water Power Company, Hudson River Power Transmission Company, Saratoga Gas, Electric Light and Power Company, Hudson River Electric Company, Hudson River Electric Power Company, Madison County Gas and Electric Company, and the Empire State Power Company.

The Court of Appeals in the Third Avenue case had held that a reorganized company could issue securities up to the limit of the securities of the old company or companies, plus any new money put into the enterprise. As the amount of securities applied for was not in excess of this stipulation, the Second District Commission felt constrained to approve the plan, and stated its position as follows:

> We know of no other question in the case upon which we are at liberty to pass. We have not found ourselves able to inquire into the value of the properties involved by reason of the decision in the Third Avenue case. No evidence has been submitted to us concerning the value of such properties. We are entirely unable to say what such value is, and it is but just to the Commission that it should be of record that it makes the decision in this case, authorizing the capitalization proposed by the plan of reorganization, *without reference to the value of the properties to be taken over*[9] by the new corporation, solely because the law as interpreted by the Court of Appeals compels us to make such decision.

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[9] Italics not in original.

CHAPTER XVII

Reorganization Under the Public Service Commission Third Period

For the purpose of remedying the defect in the powers which the Public Service Commissions Law gave to the Commissions with regard to corporations in process of reorganization, which defect the Court of Appeals had pointed out in the Third Avenue decision, just discussed, there was prepared, in 1912, an amendment to the Law, which gave to the Commissions specific powers to base the amount of securities which they could permit such a corporation to issue upon the value of the property involved.

This amendment, Chapter 289 of the Laws of 1912, became a law April 12, 1912, and was incorporated into the Public Service Commissions Law as section 55-a.[1] It reads as follows:

> Sec. 55-a. Reorganizations. 1. Reorganizations of railroad corporations, street railroad corporations and common carriers pursuant to sections nine and ten of the stock corporation law and such other laws as may be enacted from time to time shall be subject to the supervision and control of the proper commission and no such reorganization shall be had without the authorization of such commission.
>
> 2. Upon all such reorganizations the amount of capitalization, including therein all stocks and bonds and other evidence of indebtedness, shall be such as is authorized by the commission which, in making its determination, shall not exceed the fair value of the property involved, taking into consideration its original cost of construction, duplication cost, present condition, earning power at reasonable rates and all other relevant matters and any additional sum or sums as shall be actually paid in cash, provided, however, that the commission may make due allowance for discount of bonds. Any reorganization agreement before it becomes effective shall be amended so that the amount of capitalization shall conform to the amount authorized by the commission.

Under this amendment the factors to be considered in a case of reorganization are: The fair value of the property involved; the original cost of construction; duplication cost; present condition; earning power at reasonable rates; additional sums actually paid in cash, and, lastly, all other relevant matters. The amendment was supposed to repeal the reorganization sections of the Stock Corporation Law in so far as they conflicted with the jurisdiction of the Commissions, and to give the latter full power to base the capitalization of reorganized companies upon the value of the property. In other words, to give the Commissions the

[1] The same amendment was made to the corresponding sections of the Law which dealt with the other classes of utilities.

powers which they thought the general spirit of the law, as originally enacted, had conferred upon them.

One of the first cases to come up subsequent to the adoption of the reorganization amendment was that of the Mid-Crosstown Railway Company, a newly organized corporation.[2] This was an application for approval of an issue of $500,000, of stock and $500,000, of bonds, to be delivered to the bondholder's committee in exchange for the property of the Twenty-eight and Twenty-ninth Streets Crosstown Railroad Company, which had been purchased by the committee.

The Commission estimated the value of the property upon the basis of reproduction-new. Allowance was made, among other items, for depreciation; also, for additions for preliminary and developmental expenses, cost of property owner's consents, franchises and permits, interest and taxes during construction, and organization expenses of the new company. Upon this basis the Commission arrived at the conclusion that the fair value of property owned and operated did not exceed $165,000, and, including property owned but not operated, not over $180,000.

It was shown that the earning power of the property at reasonable rates was not sufficient to enable the new corporation to pay even operating charges, if the system was operated as a separate unit. If operated in connection with a larger system, it might earn more, but how much more was uncertain. The bonds alone would exceed the fair value of the property, upon whatever basis it might be estimated. Hence, there could be no justification for issuing $1,000,000, of securities, and the application was denied.

In the Second District, also, during this period, an important case was decided in accordance with the powers conferred by the new reorganization amendment. This was the case of the Westchester Street Railroad Company.[3]

The value which the Commission put upon the property in this case was arrived at, principally, through a study of its earning power. While, in view of the 1912 amendment, the Commission felt that it had a free hand to base the amount of securities approved upon the value of the property, that value seemed a very difficult matter to get at in this case, and earning power was given importance for that reason.

[2] Matter of the Petition of the Mid-Crosstown Railway Company, Inc., for authority to issue certain stocks and bonds, 3 P.S.C.R., 1st Dist., N. Y., 416. Opinion adopted November 1, 1912.

[3] Matter of Application of the Westchester Street Railroad Company for authorization to issue capital stock, 3 P.S.C.R., 2nd Dist., N. Y., 286. Decided April 24, 1912.

The property involved had formerly constituted the Tarrytown, White Plains and Mamaroneck Railway Company, and had been sold at a judicial sale because of the foreclosure of underlying bonds. Practically the whole property had been bid in at the sale by an individual, and the applicant company had been organized for the purpose of taking over and holding the property. The individual had turned over his bid to the present applicant corporation, which now asked for authorization to issue capital stock in the amount of $912,000 to make the purchase, and to cover certain expenses incurred by the corporation in connection therewith.

The outstanding bonds amounted to $247,000. These had been acquired in 1909 by the New York New Haven and Hartford Railroad, which had subsequently caused the foreclosure to be instituted with a view to acquiring the road, and, in the present application, the New York New Haven and Hartford made a joint application for the consent of the Commission to take and hold the entire capital stock authorized.

As to the primary applicant, the Westchester Street Railroad Company, it was held that it was entitled by law to take and hold the property involved and was entitled to issue stock for it. The question was how much stock should be issued for the property.

The Commission was at loss for a proper method or for reliable clues by which to fix values in this case and yet felt that any result at which it might arrive must have some basis in precedent. So a survey was made of judicial decisions bearing upon valuations of property arrived at by various methods and for different purposes, such as tax assessment, fixing of rates, etc., with the idea of finding what rule, if any, the courts had used in ascertaining value.

The conclusion seemed to be that the courts had arrived at no definite system, and that the Commission would have to do the best it could with the data on hand. A review of various court decisions showed that the three principal classes of cases in which there had been a determination of the value of property by governmental authority were: Assessments for the purposes of taxation; valuations in the fixing of rates to be charged by public service corporations; and valuations necessary in the authorization of the capitalization of such corporations. In the first two classes, rules for the fixing of value had been laid down, but in the last class it seemed that no definite rules had been formulated and that the subject was open to the freest discussion.

In many of the earlier tax cases use had been made of the method known as "commercial valuation," which is arrived at by ascertaining

the cash, or market value of the shares of stock, and of the funded debt. In one United States Supreme Court case consideration was given to three theories; commercial value, net earning power capitalized, and cost of reproduction.[4] The idea of cost of reproduction is discussed and negatived for purposes of taxation, while the theory of determining value by net earning power is vigorously supported. The United States Supreme Court cases in which methods of valuing the property of solvent corporations for taxation purposes was involved seemed to favor the commercial method of valuation as most satisfactory.

In the present case, the evidence available made it impossible to ascertain actual cost. The securities of the corporation which had owned the property had no value, so that commercial valuation was impossible. Reproduction cost could be approximated, and would, it was held, be highly desirable to existing investors, as it would, to a large extent, eliminate business risks.

Danger of Placing Undue Stress Upon Earning Power

The Commission undoubtedly had a difficult problem to solve in arriving at concrete figures. In seeking to apply the rule that securities should not be issued in excess of an amount upon which there was a reasonable certainty that a fair return could be paid, it was necessary for it to consider the earning power of the property as a check upon the amount of securities. But to give to earning power, as a test of value, the unusual emphasis placed upon it in this case seems totally unjustifiable. It may not lead to embarrassing results in the case of a utility whose rates are reasonable, but if the test could be applied to such cases, it could also be applied to cases where the rates might be exorbitant. Earning power and commercial valuation are practically identical, for the market value of securities is based upon earning power, and an issue of securities based upon the value of a property, as indicated by its earning power, may, in a subsequent rate case, place a Commission in the position of being between 'the devil and the deep sea,' as regards the investing public on the one hand, and the consuming public on the other. This feature received special emphasis in Commissioner Maltbie's opinion upon the first reorganization plan submitted by the bondholder's committee of the Third Avenue Railroad.[5]

[4] Adams Express Company v. Ohio State Auditor, 165 U. S. 194. Decided February 1, 1897, and 166 U. S. 185, decided March 15, 1897.

[5] See 2 P.S.C.R., 1st Dist. N. Y., 121.

The evidence in (the present) case gave the following bases from which to determine the value of the property:

1. Reproductive cost less depreciation.

2. Past earning power of the road, with a general knowledge of the prospects for future growth and business.

3. Price which the property realized at open competitive sale.

A valuation made by a well-known firm of appraisers gave total duplication cost as $862,839, less depreciation of $183,271, leaving $679,568. This was thought to be too high, and a second appraisal was carried through in conjunction with the engineer of the Commission, giving a total reproductive cost, less depreciation, of $445,694.

A study of earning power showed that under the old managment the property had been a bad loser and had operated with a deficit exclusive even of fixed charges and depreciation. It appeared that the road was saddled with a franchise which required it to carry passengers from Mamaroneck to White Plains for five cents. This could be done only at a loss. The operation under the new management had seen a considerable increase in gross earnings, with prospects of continued improvement, but the road would still be saddled with the aforementioned franchise.

To increase the earnings of the road, large sums must be spent upon improvements, which capital would have to be raised by bonds. If the amount of stock ($900,000) for which authorization was asked, were issued, it, together with the necessary bonds, would constitute a fixed capital, the payment of a return upon which the present prospects of the road did not in any way justify.

The price paid for the property at the judicial sale was $882,400. The evidence, however, showed that no investigation as to earning power had been made, no inventory and appraisal, nor any engineering estimate as to reproductive cost. In addition, the purchaser had considered franchise value, and this it was illegal to capitalize.

Moreover, subsequent investigation showed that large parts of the road would have to be rebuilt. In view of these facts $400,000 was considered by the Commission to be a just estimate of the value of the road at the time of the purchase.

The applicant sued out a writ of *certiorari* and had the case reviewed by the Appellate Division of the Supreme Court, and the latter reversed the order of the Commission both upon the law and the facts.[6] The

[6] People ex rel. The Westchester Street Railroad Company and the N. Y., N. H. and Hartford R. R. Co., v. Public Service Commission, 158 App. Div. (N. Y.,) 251. Decided July 8, 1913.

finding of fact, disapproved of, as against the evidence, was that the value of the property was only $400,000. The Court held that in such cases of purchase of the franchises and property of one corporation by another at foreclosure sale, the Commission should take into consideration the amount paid upon bona fide competitive bids at a public sale.

The matter was remitted to the Commission for further consideration in accordance with the opinion of the Court, which placed primary emphasis upon purchase price in the open market as a criterion of value.

The Commission carried the case to the Court of Appeals,[7] which objected to the importance placed by the Supreme Court upon the market price as a criterion of value and ruled that the decision of the Supreme Court should be modified in this respect and that the case should be remitted to the Commission for further evidence as to the value submitted by either party.

[7] People ex rel. The Westchester Street Railroad Company et al., v. Public Service Commission, 210 U. S. 456. Decided March 17, 1914.

CHAPTER XVIII

Reorganization Under the Public Service Commissions Law—Fourth Period

The Dry Dock refunding case is of special interest because it is generally felt that it was properly a reorganization, and that it would have been so presented by the applicant company had it not been for the fact that the 1912 amendment gave the Commissions specific power to base the amount of securities issuable in a reorganization case upon the value of the property.

On July 31, 1913, the Dry Dock, East Broadway and Battery Railroad, which we shall refer to as the Dry Dock Company, presented its application for approval of the issuance of refunding securities.[1]

The road had been operated for some years as a part of the Third Avenue system, but had been in the hands of a receiver appointed by the Federal Court since early in 1908. It had outstanding capital stock to the amount of $1,200,000, practically all of which was owned by the Third Avenue Company. All the preferred claims against the Dry Dock Company had been paid by the Third Avenue Company and claims not entitled to a preference had also been acquired.

The applicant presented to the Commission a petition setting forth that an agreement had been made between it, the Third Avenue Railway Company, and a protective Committee of the holders of certain certificates of indebtedness (of a total of $1,100,000) for the refunding of all the company's debts and obligations by the issue of refunding mortgage gold bonds payable in 1960 and secured by a mortgage and deed of trust.[2]

The application asked consent to the issue of a refunding mortgage, providing for the issue of three classes of bonds as follows:

Series A bonds 5%	$1,500,000
Series B bonds 4%	520,000
Series C bonds 4% interest payable only if earned up to Jan. 1, 1925	2,240,000
	$4,260,000

The Series A bonds were not to be issued under this proceeding, but were to be kept for the purpose of refunding the outstanding general mortgage bonds which would become due in 1932, to the amount of

[1] Matter of the Application of the Dry Dock, East Broadway and Battery Railroad Company for Permission to Issue Bonds, 5 P.S.C.R., 1st Dist., N. Y. 213. De-Decision rendered April 28, 1914. See also Rehearing of same case, 5 P.S.C.R., 1st Dist. N. Y., 337. Order adopted December 11, 1914.

[2] The debts of the company at this time were as follows:

$950,000, and to provide for future capital requirements to the extent of $550,000.

Permission was now asked to issue Series B and Series C bonds, amounting to $2,760,000, for the purpose of refunding debts of the company amounting to some $3,800,000.

The item of $1,100,000 of certificates of indebtedness is of special interest. On February 1, 1884, the company had a book surplus of $1,200,000. Against this it issued certificates of indebtedness to the same amount and gave them to its stockholders according to the amount of their stock. Of these certificates and their significance we quote from the opinion of Commissioner Hayward as follows:[3]

> It (the company) had a surplus invested in property and available for depreciation purposes, but stockholders were not satisfied with 16% dividends and managed to obtain something better than a stock dividend, i.e., $1,200,000 of certificates of indebtedness. The transaction was in effect a distribution of a depreciation fund and necessarily impaired the capital of the company to the extent that it drew upon such depreciation reserve.

Certificates to the amount of $100,000 had been paid off in 1891, leaving the $1,100,000, outstanding. If the results of such financing

1. Mortgage to the Farmers Loan & Trust Co. as Trustee, being a first lien on all of petitioner's property		$950,000.00
2. Receiver's certificates issued under the order of the Court dated Apr. 22, 1911.	$350,000.00	
Accrued interest to June 30, 1913, thereon	27,330.35	
Receiver's certificates issued under the order of the Court dated July, 1913.	149,000.00	526,330.35
3. Five per cent. certificates of indebtedness issued by petitioner in the year 1892	1,100,000.00	
Accrued interest from Aug. 1, 1907, to June 30, 1913	325,416.67	1,425,416.67
4. Claim of Third Ave. Railroad based on promissory note dated Apr. 30, 1907, for $1,882,963.70. This note having been proved before the special master, the railroad company voluntarily reduced its claim to $1,500,000 at which sum it was approved by the master		1,500,000.00
5. Claims on contract and tort allowed by the special master		58,513.60
6. Claims for money expended by the Third Ave. R. R. Co. in the acquisition or settlement of claims against the petitioner		30,000.00
	Total	$4,490,260.62

See 167 App. Div. (N. Y.,) page 289.

[3] Matter of Application of The Dry Dock East Broadway and Battery Railroad Company to issue refunding bonds, 7 P.S.C.R., 1st Dist., N. Y., 59. Opinions adopted May 4 and May 25, 1916.

were not so serious, they would be amusing. A property may or may not burn down, but there is no uncertainty about its depreciating; this is as inevitable as time and tide, and a depreciation reserve is simply an insurance fund. To neglect such a need would have been incurring a heavy enough risk, but to make it a double liability by issuing, not even stock, but certificates of indebtedness with a fixed rate of interest, was absurd. The interest rate was 6 per cent, and later, 5 per cent. At 6 per cent the full amount would involve an annual charge of $72,000 in addition to a liability of $1,200,000 and a corresponding loss of depreciation reserve.

The Commission's engineer fixed the value of the applicant's property at $2,470,306. The company offered no evidence along this line. The Commission finally denied the petition by a majority vote, for three reasons, first, because of lack of proof that the securities to be refunded represented proper capital charges, second, because the value of the property was less than the amount of the securities for which approval was asked, and third, because earnings would not be sufficient to pay interest on the bonds.

A rehearing was asked. This was granted, but, after further testimony, the application was again denied.

The company then sued out a writ of *certiorari* and the Appellate Division affirmed the Commission's decision in denying the petition, but held[4] that the Commission had no power to use the value of the property as a basis or test in considering the propriety of security issues for refunding purposes.

The position of the applicant in this case was the same as that taken by several applicant companies in reorganization cases prior to the 1912 amendment, namely, that where a public utility had outstanding obligations issued before the Public Service Commission Law went into effect, the Commission's jurisdiction was purely ministerial.

The company evidently thought it had discovered another "twilight zone" similar to that which had existed in the case of reorganizations, and the decision of the court seemed to bear them out.

The court (Appellate Division of the Supreme Court) held that the 1912 amendment applied exclusively to reorganizations, and hence, refunding of securities occupied the same status with regard to the jurisdiction of the Commission that it had always done, the same as

[4] People ex rel. Dry Dock, East Broadway and Battery Railroad Company et al. v. Public Service Commission, 167 App. Div. 286. Decided May 7, 1915.

that occupied by the issuance of securities upon a reorganization plan prior to the 1912 amendment.[5]

It is hard to see the logic of the position assumed. The Court of Appeals in the Third Avenue case determined that the Public Service Commissions Law did not make the actual value of the property of the corporation the basis for the issuance of securities under a reorganization plan because there existed a specific statute (Stock Corporation Law, Sections 9 and 10) dealing with reorganizations, which, it was claimed was not repealed by implication by the general terms of the Public Service Commissions Law. But there was no specific statute existing which related to the refunding of securities, nothing to be repealed by implication or otherwise with which the general purposes of the Public Service Commissions Law would have to contend, and, therefore, the reasoning of the court in the Third Avenue decision does not seem to be applicable to the present case.

However, by the terms of the court's decision the value of the property as a test for securities to be issued in refund is discarded. The real question, the court contends, is whether the Public Service Commissions Law does vest the Commission with the power of inquiry into the application of the funds represented by the securities sought to be refunded, by determining that such funds were actually applied to capital account and by limiting their approval of new securities to those required to refund obligations representing actual additions to capital.

While, as an original proposition, the court argues, it might hold that the commission had no power to do more than determine whether the

[5] The court in its decision just referred to, says: "It (the reorganization amendment of 1912) did not apply by its terms to the other possible means of disposing of its property (1) by merger, or (2) by voluntary sale. Nor did the provisions of Section 55-a reorganization amendment apply to the refunding of the existing obligations of a which it was not proposed to reorganize in anticipation of a sale, or thereafter. The reasoning of the Court of Appeals in the Third Avenue case, in determining that the statute did not make the actual value of the property of the corporation the basis for the issuance of securities under a reorganization plan, it seems to me, is equally applicable to the issuance of refunding securities, and the value of the mortgaged property can have no bearing upon the amount of new securities to be issued under the refunding plan. Applying the reasoning of the Court of Appeals to the question at bar, which is unaffected in any way by the subsequent amendment by the Legislature referred to, it would seem that unless there is some special language in the provision of the statute relating to refunding which differentiates it from the provision for reorganization, the functions of the Commission do not include a determination of the value of the corporate property as a basis for the amount of new securities to be issued in refund."

original securities were validly issued, and whether the aggregate of the issues to be refunded did not exceed them in amount, the language in the Binghamton case,[6] which, the Court claimed, amplified that in the Delaware and Hudson case,[7] made it clear that the commissioners were charged with "a fuller and further duty." Said the court:

It is there laid down as the settled policy of the State that the commissioners, in their duty of protecting the public can and must determine, before they give their consent to the issue of refunding securities, that the purposes for which the original securities were to be issued were strictly capital purposes, and not expense or operating purposes, and this, it will be seen, has been carried so far that the Court has required the company to provide otherwise than by bonds for the expenses attending the ordinary renewal of its plant. The language used in the Binghamton case is so broad that it applies to every application for refunding, no matter when the original securities were issued.[8]

Conclusions of the Court Upon a Commission's Powers in a Refunding Case

The Court summarized its conclusions[9] as follows:

While, therefore, the commission was wrong in applying the test of the actual value of the company's property and its earning capacity as a criterion for its approval of the issue of these new securities, it was right in refusing to approve their issue until the relator had proven that the securities sought to be refunded represented actual investments for the company's capital account. . . . Therefore, it seems to be quite immaterial how long ago the original securities were issued where the approval of the commission is sought to a refunding issue and proof of such investments must still be given as a basis for the action of the commission. . . .

I therefore reach the conclusion that in a refunding case the inquiry of the Commission is properly directed to the following considerations, the evidence requisite to reach a determination whereupon should be furnished by the petitioner: (1) Whether

[6] People ex rel. Binghamton Light, Heat and Power Company v. Stevens, 203 N. Y., 7. Decided October 3, 1911.

[7] People ex rel. The Delaware and Hudson Company v. Stevens, 197 N. Y., 1. Decided December 7, 1909.

[8] As regards the responsibility of the Commission to the investing public and the significance of its approval the Court goes on to say (167 App. Div., 286): "The fact that the effect of such a refusal to a refunding plan in a single case may be disastrous, as it is very apt to prove in the present one, is not the controlling consideration, but rather, that under the settled policy of the law as now determined by the Legislature and interpreted by the courts, the approval of the commission to the issue of new securities, whether it be for refunding or other purposes, is notice to the public that the securities so authorized by it represent at least investments made by the Company for capital account and not disbursements for mere temporary purposes."

[9] People ex rel. Dry Dock, East Broadway and Battery Railroad Company et al. v. Public Service Commission, 167 App. Div., 286. Decided May 7, 1915.

the proposed issue is reasonably required for the refunding purpose. (2) Whether the expenditure to be refunded is a capital, as distinct from an operating or income, charge. (3) If the expenditure to be refunded is an operating or income charge, whether such refunding should nevertheless be permitted under the exception clause of the statute which reads: "Except as otherwise permitted in the order in the case of bonds."[10]

The Commission, in compliance with the mandate of the Court, proceeded to examine the securities which it was proposed to refund upon the basis of question 2 (as above).[11]

They came to the conclusion that the maximum amount that could be allowed was $1,828,385, as compared with the $4,260,000, asked for.

The final question was whether the Commission should use its discretion under the statute and as outlined under question 3 above, to allow the issue of the rest of the Series C bonds, amounting to $931,615, for the refunding of debts which the Commission could not certify as not being chargeable to operating expenses or to income.

The Commission stated that while it was true that the certificates of indebtedness had been bought in good faith and were widely held, sympathy for those wronged in the past should not be allowed to lead to the deception of future investors. Moreover, it was held that the issuing of bonds for operating expenditures would be feasible only if the same could with certainty be amortized rapidly from income. As the evidence in the case gave no promise of the possibility of such amortization, or even of interest payment, their issue, it was decided, would be wholly unjustifiable.

The Court had held that the Commission was wrong in applying the test of the actual value of the company's property and its earning capacity as a criterion for its approval of the issue of the new securities. Inasmuch as the Commission's decision had, however, been affirmed by the Court, it was impossible to appeal from this ruling to the Court of Appeals. This was unfortunate as it leaves the jurisdiction of the Commissions undecided in regard to future applications for refunding issues. In the words of Commissioner Hayward:

One of the broad underlying purposes of the Public Service Commissions Law was to insure against over-capitalization, and it has always been the proud boast of this Commission that securities would not be authorized beyond the value of the property subject to them, or under such circumstances that it could not reasonably be antici-

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[10] Bonds permitted under the proviso are generally made subject to rapid amortization.

[11] Matter of Application of the Dry Dock, East Broadway and Battery Railroad Company, 7 P.S.C.R., 1st Dist., N. Y., 59. Opinions adopted May 4 and 25, 1916.

pated that the interest thereon would be paid. The decision of the Appellate Division however held that in the case, at least, of refunding securities, the value of the company's property and its ability to pay interest upon the proposed issues could not be considered by the Commission. Under that decision, therefore, the purpose of the Public Service Commissions Law in this respect might very well be frustrated and refunding bonds insufficiently secured might very well be issued with the approval of this Commission stamped upon them to hasten them into the hands of the unwary investor."[12]

This is the present situation which seems to point to a serious defect in the law, and which can be remedied only by a change of judicial interpretation or by an amendment to the Public Service Commissions Law.

[12] See 7 P.S.C.R., 1st Dist., N. Y., page 83.

PART FIVE

CONSOLIDATIONS, MERGERS AND TRANSFERS OF STOCK

Consolidations, mergers and stock transfers have so many points in common that it seems practical to treat of them together. Consolidations and mergers have been grouped in one chapter and stock transfers in another.

CHAPTER XIX

Consolidations and Mergers

Consolidations and mergers are very similar. In a consolidation we have the union of two or more existing companies into a new company in which the former companies lose their identity. A merger, on the other hand, is the absorption by an existing company of one or more other existing companies into its organization. In this case the original company preserves its identity.[1] The provision of the Public Service Commissions Law dealing with consolidations and mergers provides that their capital stock shall not exceed the sum of the capital stock of the constituent companies at its par value, plus any additional sum paid in cash.[2]

It is further provided that no contract for consolidation or lease shall be capitalized, nor shall any bonds be issued as a lien upon any contract for consolidation or merger. The provisions of the law relating to consolidation and mergers are as originally enacted. Before the passage of the Public Service Commissions Law, corporations had a legal right to consolidate without the authorization of anyone outside of their own corporate organizations. Since then they have had the same right subject to the authorization of the proper commission.

[1] In this connection we quote from the headnote of the case of *Lee* vs. *Atlantic Coast Line Railroad Co.*, 150 Fed. Rept., 775, as follows:

"There is a distinct difference between the consolidation and the merger of two railroad companies. In a consolidation both go out of existence as separate corporations and a new corporation is created which takes their place and property; while in the case of a merger one loses its identity by absorption in the other which remains in existence and succeeds to its property and issues its own stock to the stockholders of the merged company."

[2] This provision is practically identical in its application to all classes of public utility corporations and reads as follows:

"Nor shall the capital stock of a corporation formed by the merger or consolidation of two or more other corporations exceed the sum of the capital stock of the corporations so consolidated, at the par value thereof, or such sum and any additional sum actually paid in cash; nor shall any contract for consolidation or lease be capitalized in the stock of any corporation whatever; nor shall any corporatin hereafter issue any bonds against or as a lien upon any contract for consolidation or merger." See Public Service Commissions Law—Chapter 48 of the Consolidated Laws of New York.

This point was thoroughly threshed out in a case involving the Watertown Light and Power Company.[3] The applicant in this case disputed the necessity of a commission's approval of a proposed consolidation. The Commission held that the Public Service Commissions Law expressly provided that there should be no transfer of franchise, works, or system of any gas or electrical corporation without the written consent of the Commission,[4] that while the Public Service Commissions Law did not repeal the older laws, it did add something to their requirements, and placed a limitation upon the effectiveness of such provisions of law whereby the transfer constituting the consolidation is restrained until approved by the Commission.

There was no question of any repeal of statutes, the Commission held. All the requirements necessary under the older laws remained in full force; but there had been added one other—the consent of the proper Public Service Commission.[5] Thus, the Commission held, a gas or electrical company might sell its office furniture, or any other of its possessions which were not vital, but, without the proper consent of the Public Service Commission, it might not dispose, by sale or lease, of the three things which are essential to its very existence as a public service corporation: its franchise, its works, or its system.

The Commissions Have no Power to Compel Consolidation

On the other hand, the Commissions have no powers to compel a consolidation or merger. In a Second District case,[6] the Commission had granted certain applications as to issues of stock and stock transfers upon the understanding that the consolidation which formed part of the proposed plan would be consummated. The opinion closed as follows:

> It (the Commission) realizes that it has no powers to compel the consolidation or the merger, and that these acts (said consolidation) will take place depends upon the

[3] Matter of Application of the Watertown Light and Power Company and the Watertown Gas Light Company for approval of a consolidation, 1 P.S.C.R., 2nd Dist., N. Y., 496. Decided March 9, 1909.

[4] See Public Service Commissions Law, Section 70. Chapter 48, Consolidated Laws of New York.

[5] The Public Service Commissions Law in this connection holds as follows:

"No gas corporation or electrical corporation shall transfer or lease its franchise, works or system or any part of such franchise, works or system to any other person or corporation . . . without the written consent of the proper Commission."

[6] Matter of Application of the New York Central and Hudson River Railroad Company for leave to acquire certain stocks, 1 P.S.C.R., 2nd Dist., N. Y. 294. See bottom page 318.

good faith of the parties which is pledged to the same, and of which pledge these remarks are to remain as the evidence.

A Proposed Consolidation Must be the Subject of a Formal Application

Nor can the merits of a proposed consolidation be determined in a collateral way upon a mere application for approval of the execution of a mortgage, etc. A consolidation must be the subject of a formal application. Provision must be made for notice to minority stockholders, notice to nonconsenting bondholders, notice to the public, and for a full investigation by the Commission with an opportunity for the cross-examination of witnesses.

In a case in point there was presented a comprehensive plan involving approval of certain proposed mortgages, exchange of certain issues of 3½ per cent bonds for new 4 per cent bonds and the taking in of certain railway properties by consolidation.[7] The approval of the proposed mortgages was the first step and was all that was asked for in the application. This was granted with the distinct understanding that it did not in any wise commit the Commission to the approval in advance of the proposed consolidation or the proposed exchange of bonds.

Scope of the Public Service Commissions Law as Affecting Consolidation

The provisions of the law which require the consent and authorization of the Commission do not state for what reasons such authorization and consent may be refused. It would seem that the Legislature left such reasons to be worked out by the commissions themselves in accordance with the object and purpose of the Public Service Commissions Law.

The theory of the Public Service Commissions law, especially in view of the Delaware and Hudson decision, would seem to be to leave the management and control of a corporation subject to the jurisdiction of the Commission wholly to the authorities within the corporation, as before the enactment of the law. The Commission, however, has power to regulate the corporation in those cases over which the Legislature has given it jurisdiction.

The veto-power of the Commission was evidently intended to be used in the case of a proposed act of a corporation only when such act was against public interest or contrary to law. If the Commission goes be-

[7] Matter of Application of the New York Central and Hudson River Railroad Company for leave to execute certain mortgages, 4 P.S.C.R., 2nd Dist., N. Y. 23. Decided November 19, 1913.

yond this, it will be assuming the administration of the corporation. Public interest consists, firstly, of the consuming public, in relation to the quality of service rendered and the prices charged; secondly, of the investing public, in relation to the value of the securities issued by public service companies.

Many Harmful Results of Consolidation Eliminated by Commission Control

In many cases of merger, consolidation and stock transfer, in which, before the enactment of the Public Service Commissions Law, there might have been serious objections on the score of public interest, such objections have been completely done away with by the control which the commissions may exercise. For instance, where consolidation was formerly used as a means of inflation of capitalization, or for the perfecting of a monopoly with increases in prices charged to consumers, such objections would not now exist under commission control.

In cases of merger where the merger company issues stock to the stockholders of the merged company or companies, the commissions may prevent the issue of a large amount of stock upon a possibly fictitious basis. In permitting an issue of stock or bonds for the purchase of other stock, the commissions ascertain, as far as possible, that the value of the stock purchased is substantially equal to the par value of the new stock issued.

Such a case was the application of the Elmira, Corning and Waverly Railway[8] for permission to issue bonds with which to purchase the stock of certain other small railroads, pursuant to a plan of consolidation. The application was denied because of failure of the applicant to show proof that the value of the properties to be purchased warranted the price to be paid.

Ascertainment of Value of Securities

Any accurate valuation of securities in such a case seems out of the question without a detailed investigation of the property involved. About all that can be arrived at in the average case is an approximation, based upon a consideration of the physical extent and condition of the properties, the equipment, the gross earnings for a period of years, the total indebtedness and fixed charges, and the total of the capital stock.

[8] Matter of Application of Elmira, Corning and Waverly Railway, 1 P.S.C.R., 2nd Dist., N. Y. 328. Decided July 23, 1908.

Bases for Permission to Consolidate

Most applications for consolidation which have come before the New York State Commissions have based their claims upon two factors, namely, the effecting of economies in the matter of operation, overhead expense, etc.; and the advantage gained in the matter of enlargement of credit for the issuance of securities for extensions and improvements.

The first ground applies especially to cases of several small plants or of plants in small towns in the same locality, while the second applies to the increased borrowing capacity of a consolidation as compared with that possible to several individual plants. A consolidation makes the basis of security much broader by spreading the risk, and the economies in operating and overhead expenses which may be possible also add proportionately to such security. Thus, a consolidation of small plants may secure from investors lower rates of interest than would be possible for the same plants as separate units and thus be enabled to give better service to all consumers involved. Most of the cases involving consolidation have been in the Second District. It would seem that in the First District, consisting of Greater New York, the process of consolidation had been carried out in most cases before the enactment of the Public Service Commissions Law.

Two Second District cases, that of the Lockport Light, Heat and Power Company,[9] and that of the Watertown Light and Power Company,[10] stand in marked contrast and serve to bring out some important elements of public advantage or disadvantage involved in consolidation, and also the difficulty of laying down any rule applicable to all cases, especially in a period of transition and readjustment.

The Lockport Light, Heat and Power Company, a newly organized corporation, had been formed for the purpose of taking over the property and franchises of the two existing electric companies and carrying on the business of supplying gas, electric light and power, and steam heat in Lockport through the agency of a single corporation. These two companies, which had been engaged in bitter competition for some years past, were the Lockport Gas and Electric Light Company, with capital stock of $150,000, and outstanding bonds of $300,000, and the Economy Light, Fuel & Power Company with capital stock of $250,000, and no

[9] Matter of Application of the Lockport Light, Heat and Power Company, 1 P.S.C.R., 2nd Dist., N. Y. 12. Decided October 31, 1907.

[10] Matter of Application of the Watertown Light and Power Company and the Watertown Gas Light Company for approval of a consolidation, 1 P.S.C.R., 2nd Dist., N. Y. 496. Decided March 9, 1909.

outstanding bonds. Thus the total capitalization of the two companies was $700,000.

The applicant company proposed to issue in capital stock $600,000, and in bonds $600,000, making a total of $1,200,000. This would have been an excess of $500,000 of capitalization over the sum of the capital stock of the two corporations consolidated.

When Bonds are Capital Stock

The companies contended that the prohibition in the law related to an increase of capital stock and did not apply to bonded indebtedness in which case the proposed issue would have been technically within the law.[11] The Commission, however, held that even if bonded indebtedness was not mentioned in the prohibition, the purpose behind the statute was perfectly clear, and that if the restrictions as to increase of capitalization could be evaded by allowing the aggregate amount of stock of the purchased companies to remain unchanged while at the same time a heavy additional burden could be imposed upon the community through a greatly increased issue of bonds, then the provision would fail in its purpose. It was quite clear, the Commission felt, that where two or more gas or electric companies in any community were permitted to sell out their property and franchises to a newly formed company, approval of such sale should be withheld, unless the *total capitalization* of the new company, whether in stocks *or bonds*, issued in exchange for the securities of the old companies, did not exceed the total capitalization of the purchased companies. And therefore, instead of the $1,200,000 asked for in the present case, the Commission held that only $700,000, the total capitalization of the vendor companies, should be allowed.

Feasibility of Competition in Gas or Electric Utilities

The municipal authorities of Lockport feared that after the consolidation took place the prices for gas and electric light and power would be raised. The applicant company, on the other hand, was willing to file a written agreement with the Commission that it would not increase the present rate of schedules without the consent of the Commission. This phase of the matter, however, brought before the Commission a question which it considered of great importance in its general application, and

[11] The law says on this point (Public Service Commissions Law, sec. 69): "Nor shall the capital stock of a corporation formed by the merger or consolidation of two or more other corporations exceed the sum of the capital stock of the corporations so consolidated, at the par value thereof, or such sum and any additional sum actually paid in cash."

which was discussed at some length. "A business which supplies to a community a public utility like gas, or electricity for light or power," the Commission observed, "is one in which free and full competition between two companies engaged in the same business cannot be expected to prevail permanently."

The Commission felt that the Legislature had these facts in mind in framing the Public Service Commissions Law, inasmuch as the provisions of the latter allowed such wide discretion to the Commissions. Consolidations, directly or indirectly, are forbidden without the approval of the proper Commission. At the same time, however, they can be permitted, if, in the opinion of the Commission, they would be to the public advantage. Abuses of such permission can be checked through the plenary powers with which the Commissions are vested in the fixing of standards of quality in the various services rendered, through the power of fixing maximum prices, and of ordering such improvements in manufacture and distribution as they may see fit. In short, the Commission held, the Law leaves consolidations to the discretion of the Commissions, each case to be decided upon its merits.

The Commission was convinced that the reduction of the capital to the aggregate of that of the constituent companies and the stipulation in the transfer that the prevailing schedule of rates should not be altered without the consent of the Commission fully protected the public against any disadvantage, while, on the other hand, great advantage might be expected to result from the avoidance of duplicate developments and the large and important economies that could be effected as the result of such combination.

Feasibility of Competition in Gas and Electric Utilities

In sharp contrast with this was the Watertown case.[12] Two companies, the Watertown Light & Power Company, supplying electricity, and the Watertown Gas Light Company, supplying gas, sought approval for a consolidation.

The petition was strongly opposed by the city of Watertown, which contended that such a consolidation would be very injurious to the financial interests of the city, that the people would be at the mercy of a monopoly, and that in case an effort was made by the city to obtain cheaper service in either or both of these utilities there should be no

[12] Matter of Application of the Watertown Light and Power Company and the Watertown Gas Light Company, 1 P.S.C.R., 2nd Dist., N. Y., 496. Decided March 9, 1909.

merger which would confound the capitalization of the electric company with that of the gas company.

In the view of the Commission, the case resolved itself into a broad question as to whether the interests of a community would be best served in the long run by the merger of two companies, one furnishing gas and the other electricity. In this case there would be a consolidation of all the light-supplying companies in Watertown.

The applicant companies laid great stress upon the decision of the Commission in the Lockport case, just discussed, in which the merger of two lighting corporations had been approved. In that case, however, one company supplied electricity, and the other both gas and electricity. That is, both companies involved in the consolidation already supplied electricity, and the principal reasons given for sanctioning the merger rested upon the fact that the two companies were already engaged in the same kind of business.

In the opinion in that case emphasis had been laid upon the economies possible in the elimination of duplicate equipment, etc., and especially, upon the similarity of the businesses of the two companies proposing to merge. The case under discussion, however, involved two companies supplying a different service, and, therefore, the reasoning in the Lockport case did not apply.

The question here at stake was whether two companies, supplying different public utilities should be allowed to merge. Generally speaking, the Commission reasoned, it was impracticable that there should be entire freedom for every individual or corporation that saw fit to establish a gas company, or run a line of street cars. Such utilities would inevitably be restricted, and efforts to force competition often resulted in such undesirable duplications of equipment as had existed in Lockport, since public service corporations were essentially monopolistic.

But this case did not show any positive advantage to the public, for the merger of a gas corporation and an electric corporation, the Commission held, "does not offer the advantages of eliminating unnecessary duplication of plants and distributing systems; nor does it, as a result of such elimination and the consequent avoidance of economic waste, hold forth the probabilities of better service and fairer prices." While each case submitted, it was further held, should be decided upon its own prevailing conditions and merits, yet in a proposed consolidation of two companies practically controlling the service of two naturally competitive utilities, such as gas and electric light, and in whose continued competition there had existed possibilities of public advantage in the matter

of lower prices and better service, the companies involved must offer proof of some direct public benefit flowing from the consolidation which would more than counterbalance the natural objections. The application was accordingly denied.

Actual Conditions May Force Abandonment of General Principles

A further hearing was granted for argument, this time upon the merits of the case. Theory was largely abandoned, and the Commission actually reversed itself, basing its approval upon conditions peculiar to the case.

The practical identity of ownership had been mentioned in the original application, but was here emphasized. It was shown that, whatever the advantages to the public of keeping the two companies apart, they were not separate, had not been for some years, and that there was no power in the Commission to make them so. The stock of both companies was owned by one individual, and had been consolidated according to every legal requirement except the approval of the Commission.

The case presents a rather humorous aspect, as the attempts of the petitioners to ignore the jurisdiction of the Commission had resulted in casting so much doubt upon the legal status of the company that it was impossible for it to float bonds for urgently needed extensions, at least at anything like a reasonable rate of interest. This affected both the old and the proposed new securities.

If the approval of the Commission to the proposed consolidation had been secured before the filing of the agreement of consolidation in the office of the Secretary of State, the status of the companies would not have been open to question. Or if the agreement had not been filed, the legal status of the consolidation would have been definite. The Business Corporations Law stated that upon such filing "*thereupon*[13] such corporations shall be merged into the new corporation," while the Commission held that this provision was modified by the Public Service Commissions Law to the extent of requiring its approval in addition. Hence, without a final court decision, the question was whether the companies *were* or *were not* consolidated, as the agreement had been duly filed in the office of the Secretary of State but the approval of the Commission had not been obtained. If securities were issued in the names of the old corporations there was doubt as to whether there *was not* a legal consolidation; and if issued in the name of the (consolidated?) corporation there was likewise doubt as to whether there *was* a legal consolidation. As a result

[13] Italics not in original.

of this dilemma securities could not be favorably placed, and the Commission was appealed to for aid, as extensions were urgently needed for the proper serving of the public. Because of the technical predicament in which the companies had placed themselves the Commission decided to permit the consolidation. Where a decided change in law conflicts with preexisting conditions, as the Commission observed, it is almost impossible to maintain a clear-cut theoretical position.

Consolidation of Small Railroads for Broader Credit Basis

The New York Central Railroad wished to consolidate with itself three small railroads which it already had under lease: The Syracuse Geneva and Corning, the Fall Brook Railway Company, and the Pine Creek Railway Company.[14] The properties of the several companies were neither parallel nor competing one with the other, and if consolidated would form a continuous line.

The first company had outstanding capital stock to the amount of $1,325,000, the third to the amount of $1,000,000, making a total of $2,325,000. The second company had stock to the amount of $5,000,000, a total for the three of $7,325,000. The capital stock of the proposed consolidation was also to be $7,325,000, but was to be divided into $2,325,000 of common stock and $5,000,000 of preferred stock, preferred both as to dividends and distribution of assets, and entitled to 4 per cent cumulative dividends. The preferred stock was to be exchanged for the existing stock of the second company named, the Fall Brook Company, for the reason that it had no mortgage or funded indebtedness upon its property, which the other two roads did have. The three roads were already under lease to the New York Central, which had been paying 3½ per cent to the stockholders of the Fall Brook Company. Under the new arrangement it would pay them $200,000 annually instead of $175,000. The leases of the other two companies with the New York Central contained provisions by which they would, at the request of the lessee, consent to the issuance of bonds secured by mortgage for the purpose of improvements and extensions, etc. The lease with the Fall Brook contained no such provision, its property had no mortgage thereon, and none could be so placed without the consent of the stockholders. But under the proposed consolidation agreement the consolidated company

[14] Matter of Application of Syracuse, Geneva and Corning Railway Company and Fall Brook Railway Company for permission to consolidate, etc., 2 P.S.C.R., 2nd Dist. N. Y., 18. Decided April 7, 1909.

was authorized to place upon its unincumbered property a mortgage to the extent of $10,000,000, which mortgage and the indebtedness secured thereby would become a lien upon the property superior to the rights of the stockholders. For this reason the stockholders demanded the concession above outlined.

The New York Central, by virtue of the new arrangement, would be enabled to place a mortgage upon the properties as a whole. As it seemed likely that bonds of the Central, secured by a mortgage upon its entire properties could be sold easier and at a better price than would otherwise be possible, permission to consolidate was granted.[15]

Physical Valuation of Consolidated Properties as One Test

In the proposed consolidation of the Palmyra Gas and Electric Company, the Newark (N. Y.) Gas Light and Fuel Company, the New Light Heat and Power Company, the Lyons Gas Light Company, and the Wayne County Electric Company,[16] the Commission resorted to a physical valuation of the properties, although the Public Service Commissions Law does not authorize this as a test.

The plan of capitalization submitted by the applicant for leave to consolidate consisted of:

Stock	$200,000
Bonds for refunding	206,000
Bonds for discharging $96,500 of obligations to be sold at 90	107,000
Bonds to defray cost of proposed improvements ($118,500) to be sold at 90	131,500
Total	$644,500

Against this there was an estimated value by the Commission of $400,000, plus the cost of proposed improvements, $118,500, or a total of $518,500. An allowance for possible discount upon both new and old bonds for the purpose of comparing proposed capitalization with value, reduced the total of $644,500 to $579,450, leaving capitalization of $60,900 in excess of the estimated value.

[15] See also Matter of Application of the New York Central and Hudson River Railroad Company to merge with itself six small susidiary roads, 3 P.S.C.R., 2nd Dist., N. Y., 822. Decided April 9, 1913.

See also Matter of Application of the Empire Gas and Electric Company, 3 P.S.C.R., 2nd Dist., N. Y., 9. Decided July 12, 1911.

[16] Matter of Application of Palmyra Gas and Electric Company, etc., etc., 2 P.S.C.R., 2nd Dist., N. Y., 500. Decided June 22, 1910.

Allowance for Intangibles

It was held by the Commission that against such difference, allowances must be made for intangibles entering into the old capitalization, including organization, fair promotion expenses, and any items of obsolescence not fairly chargeable to depreciation, which the condition of each company's revenues might not have permitted to be deducted from income. This would also include any errors against the companies which might exist in the general estimate of present physical value.

The real purpose of such a comparison in a case of proposed consolidation, the Commission held, was to enable it to act with understanding, and, if warranted thereby, prevent a consolidation presenting large capitalization and relatively small property value. If, however, the Commission had vetoed the plan upon such grounds, it is doubtful, in the light of the Third Avenue decision, whether the court would have sustained its action, as the law does not authorize value of property as a test for permission to consolidate. It was felt that the balance of proposed capitalization over actual physical value might be fairly set off against the intangibles and other matters mentioned, and consolidation was permitted upon the basis of the total applied for, namely, $644,500.

Consolidation vs. Reorganization

The Commission emphasized the fact that this was a proposed capitalization of the properties of existing companies, and was quite distinct in the matter of allowable capitalization from a case where approval of new capitalization was sought for a new company taking over a property sold under judicial decree.

The question arises as to the distinction between the capitalization of existing companies, pursuant to a plan of consolidation or merger, and capitalization pursuant to a plan of reorganization. The mere fact of reorganization, of course, indicates that something is radically wrong, since a company in such a case has not been able to meet interest upon its bonded debt, while the companies involved in a consolidation plan may be meeting all charges and paying prosperous dividends upon stock. Besides, the issue of securities in connection with consolidation is largely in the nature of an exchange of the securities of the existing companies for those of the proposed consolidated company, whereas in a reorganization there is theoretically a wiping out of old securities, and a starting afresh with new. This does not say, however, that in certain cases, the securities of companies involved in a consolidation plan may not be in excess of the value of the property. Theoretically, therefore, there is

no reason why the test of the value-of-the-property should not apply also to consolidations and mergers, although the Public Service Commissions Law does not provide specifically for such a test.

The fact is that the Commissions have seen fit in several cases to use a valuation of the physical property as one test in judging of the property of a proposed consolidation. They have evidently gone upon the assumption, as they did in reorganization cases prior to the Third Avenue decision, that the general spirit of the law gave them the power to use the value of the property as a test. This assumption, as regards consolidations, has never been tested in the courts, as it was in the case of reorganizations. What the judicial interpretation of this point would be is, of course, problematical.

Basis of Permission to Consolidate

The chief purposes of this consolidation, as claimed by the applicants, were to introduce economies in operation by the production of gas and electricity at central points and by the transmission from the producing plant to the various localities, and to provide a broader basis for the issuance of bonds for needed extensions than could be obtained by the separate companies.

Eight reasons were found by the Commission to warrant the proposed consolidation, as follows:

(1) The present restricted ability to render good service by several of the companies, but good and full service under one company.

(2) Inability of the separate companies to market securities for refunding and improvements at fair prices, but apparent fair sale of bonds by a consolidated company.

(3) Present high percentage of operating cost to gross revenue.

(4) Reduction of operating expenses through centralization of production.

(5) Reduction of overhead or administration cost, and greater efficiency of superintendence through employment of capable management under salaries larger per man but less in the aggregate than the combined salaries heretofore paid.

(6) Increased gross revenue from extensions and good service.

(7) Greater ability to render necessary service at lower rates.

(8) The proposed consolidation would be distinguished from mere consolidation of separately operated companies by the fact that production was to be centralized and the operations were to be connected, except as separate operation might be necessary in case of breakdown in a central producing station.

Distinction Between Small Towns and Cities in Consolidation of Gas and Electric Utilities

The objection to the consolidation of gas and electrical companies, the Commission held, did not apply with great force in this case, because

in small towns or villages the consolidated company in order to increase its revenues must seek to develop both branches of its business in all practicable ways. On the other hand, in cities of considerable size the consolidated company might well favor the extension of its electric lines as against its gas mains, since the former may ordinarily be done more cheaply, and under large demand, the electric service might be found more profitable.[17] In such a case the result would be to drive consumers of gas to use electricity because of inadequate service for gas.

Permission to Consolidate Conditioned Upon Rectifying of Accounts

The application for leave to consolidate of the Poughkeepsie Light Heat and Power Company, the Newburgh Light Heat and Power Company, and the Hudson Counties Gas and Electric Company,[18] was similarly based upon economies of production and an enlarged credit basis.

An examination of the properties by the Commission's engineer and an investigation of the books of the applicants showed that each of the companies was in good financial condition, and that none of the properties was in such condition physically or financially that it would be likely to diminish the ability of the consolidated company to give adequate service at reasonable rates. It appeared that the common stock of each company could be properly exchanged share for share for that of the consolidated company. The value of each of the two larger properties was in excess of their capitalization.

On the other hand, in all three companies, the examination showed that under the accounting system used prior to the prescribing of a uniform system by the Commission, the Fixed Capital Accounts had not been sufficiently credited in the past with retirements of property. Also in many instances replacements had been charged to fixed capital. Examinations by the Commission showed that considerable amounts in each case should be written off from the Fixed Capital Account, and that various other accounting adjustments should be made, as it would be impossible to carry out such revision after a consolidation. The Commission felt that the financial statements warranted the consolidation if the

[17] See reference to so-called Douglaston case, where the company in refusing to extend its gas mains to Douglaston, based its refusal partly upon the fact that consumers in that place were already supplied with electricity. See page 242.

[18] Matter of Application of Poughkeepsie Light, Heat and Power Company, etc., for leave to consolidate, 2 P.S.C.R., 2nd Dist., N. Y., 644. Decided April 11, 1911.

proper amounts were written off, and as a pre-requisite for leave to consolidate, the following conditions were stipulated by the Commission:

(1) The writing off of proper amounts from Fixed Capital accounts.

(2) The adoption of a revised balance-sheet submitted by the Commission for the consolidated company.

(3) The making by the new company of an inventory and appraisal of the permanent assets to be included in Fixed Capital account, on a basis suggested by the Commission.[19]

(4) The maintaining by the consolidated company of separate accounts of its business as to each locality served in order that the property employed, income received, and expenses incurred in such business for each locality may be readily ascertained.

Upon these conditions it was felt that public interest would be promoted, and leave was granted to consolidate. Such an arrangement would not eliminate over-capitalization, but would segregate it so that any additions of that nature would stand out plainly.

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[19] Fixed Capital account was to be divided into Tangibles and Intangibles. These two classes were to be made up according to the following definitions submitted by the Commission:

I TANGIBLES:

(a) Tangible physical property used, useful and necessary in rendering the service. The appraisal thereof should be made on a basis of reproductive cost less deterioration to present condition; plus legitimate related intangibles pertaining to the creation of the operating faciliites, said intangibles appearing separately as a per centum of the reproductive cost.

(b) Tangible physical property not now used, useful and necessary in rendering the service. The appraisal thereof should be made on the basis of "going value" for such elements of value as pertain to the operating facilities. *Definition*: "Going value" is that value which would be placed on unused property consisting of several elements of value presumably adaptable to the ostensible purposes of the corporation.

All the foregoing shall be subdivided and charged into the appropriate accounts as designated in the definitions of accounts for fixed capital provided in the accounting orders for gas and electrical corporations.

II INTANGIBLES

The difference between the amount found for tangible physical property, as hereinbefore defined, and the amount stated in the Fixed Capital account. Said difference should appear in the Fixed Capital Account as "Other Intangible Capital." Such inventory and appraisal shall be prepared in reasonable detail under direction of the Commission, submitted to the Commission for its approval, and when so approved should be retained by the corporation as a part of its permanent records, the same being the basis for correcting the books of the corporation as to the accounts for fixed capital.

Denial of Permission to Consolidate Based Upon Absence of Proof That Securities to be Refunded Represented Capital Expenditures

In a recent consolidation case in the First District,[20] the applications were denied upon the general grounds that the proposed plan of recapitalization was inimical to the public interest and contrary to law and sound finance. The Richmond Light and Railroad Company and the Staten Island Midland Railway Company petitioned for consent to consolidate and to issue securities. The corporations were already interlocking and the Commission conceded that a consolidation would serve to bring the legal organization into closer correspondence with the actual facts and would enlarge the credit of the companies so that improvements and extensions could be better provided for.

Under the proposed plan the Staten Island Midland Railroad Company wished approval to increase its authorized capital stock from $1,000,000 to $2,350,000, the increase of $1,350,000 to be 6 per cent cumulative preferred stock. Of this, $1,000,000 was to be issued to discharge 5 per cent thirty-year bonds due in 1926, of the par value of $1,000,000, and matured and unpaid coupons (from 1910 to 1916) due upon said bonds to the amount of $350,000.

The Commission held that there was a decided advantage to be gained by substituting stock for bonds, as the stock would be free from the liability of foreclosure upon default of interest. There was, however, a 20 per cent increase in interest charge. But the most important requisite in such a change is proof that the original proceeds were expended upon capital as distinct from operating account. Such proof the company failed to present.

The Public Service Commissions Law, while frowning upon the issuance of securities for other than strictly capital account, does permit the Commission, in its discretion, to authorize the issue of bonds or short term notes for purposes chargeable to operating expense or to income. This is sometimes done as an emergency measure, and is usually permitted upon condition that such issues shall be amortized as rapidly as possible. Such a course would be justified where a company was faced with the alternative of a receivership and yet showed a reasonable prospect of being able to pay amortization charges upon a bond issue if allowed to continue in business. But the issue of stock upon such a basis

[20] Matter of the Applications of the Richmond Light and Railroad Company and the Staten Island Midland Railway Company, 8 P.S.C.R., 1st Dist., N. Y., 111. Opinion adopted May 9, 1917.

is expressly forbidden, as this would constitute a permanent capitalization of a charge which at best should be of temporary duration.

Of the preferred stock proposed to be issued by the Staten Island Midland Railway Company, $350,000 was to be used to refund a like amount of unpaid interest coupons. The applicant claimed that these constituted "property," and that securities could properly be issued for them under the "acquisition of property" clause of Section 55 of the Public Service Commissions Law. The Commission held that the "extinguishment by one of his own debt is not an acquisition of property." Such a theory, it was held, could logically be extended to the capitalization of all operating charges by first issuing for them evidences of indebtedness and then discharging same by an issue of stock or bonds.

As to the purpose for which the proceeds of the obligations involved in this case had originally been expended, no proof was offered, but it was admitted in the petition that there was included taxes, interest, and other operating charges, together with an indefinite amount of replacements. As the policy of the Commission was to permit capitalization of replacements only under conditions of rapid amortization, the petition was denied without prejudice to a subsequent plan eliminating the objectionable features of the present one.

CHAPTER XX

Stock Transfers

The provisions of the original law of 1907 covered railroad, street-railroad, gas and electric corporations, and provided that a public utility corporation should not acquire, directly or indirectly, the securities of a like corporation, except with the authority of the Commission; that except where stock should be transferred or held for the purpose of collateral security, and this only with the consent of the Commission, no stock corporation of any description, domestic or foreign, other than a public utility corporation of the kind under consideration, should acquire or hold more than 10 per cent of the total capital stock of any other such public utility organized under the laws of New York State. Thus stock of a railroad or street railroad corporation in excess of 10 per cent of the total could be held only by a railroad or street railroad corporation. Nothing in the act was to be construed as preventing the holding of stock heretofore lawfully acquired, but any contract or transfer by or through any person or corporation to any corporation, in violation of any provision of this chapter, should be null and void.

An amendment added in 1910 made an exception in the case of a corporation which already held a majority of the capital stock of a public utility. Such a corporation could, without the consent of the Commission, acquire the remainder or any portion thereof.

Another 1910 amendment made provision that where stock so held should be surrendered pursuant to a reorganization a proportionate amount of stock of the new corporation could be acquired and held. And in the same connection there was added in 1914 a further amendment, applying only to railroads and street railroads, as follows: ". . . subject to approval by the Commission (the acquiring or holding of a proportionate amount) of any further issue of stock, provided such further issue does not increase the proportion of stock held by such stock corporation."

In 1911 an amendment to the railroad section included electrical corporations along with railroads and street railroads as corporations which could not acquire or hold stock in like corporations without the consent of the Commission, and of whose stock not more than 10 per cent could be held by any corporation other than such a public utility corporation. This change was occasioned by the growing importance of electricity as a motive power, and the frequency with which railroads

and street-railroads purchased power in large quantities from electrical corporations.

At the same time an amendment was added to the gas and electric section prohibiting the acquisition or holding of the stocks or bonds of any electrical corporation by a street railroad corporation. The parallel sections applying to telegraph and telephone corporations and to steam heating corporations, are substantially identical and were added in their entirety as part of the articles in which they occur, the former in 1910 and the latter in 1913.

Principal Questions Involved in Transfers of Stock

In all cases involving transfers of stock, the question of advantage or disadvantage to the general public has been given most weight, especially where such transfer meant the absorption of a competing company or the extension of monopoly influence into new territory. Other questions have been the proper protection of minority stockholders, and the reasonableness of the prices to be paid for the stock acquired. As in many cases the stocks have been unlisted, the problem has been difficult of attack.

As with consolidations, the treatment of cases of stock transfer shows little development of trend. In fact the anomalous conditions consequent upon such a decided change of administrative control as was represented in the enactment of the Public Service Commissions Law seemed to make a settled policy impracticable for some years at least until the necessary readjustments had had a chance to work out. This was especially true in the Second District and in more than one case the Commission realized that in endeavoring to stick to principle, it would, in effect, be depriving a community of facilities and service urgently needed. The handling of cases of stock transfers has, therefore, constituted a period, largely, of readjustment and a resumé of the important cases may seem somewhat haphazard.

Dissolution of Holding Companies Made Advisable by the Public Service Commissions Law

The first important case of stock transfer in the Second District involved a typical holding company, and showed in an interesting way the effect of the change in law as compared with the free and easy methods previously pursued. The Mohawk Valley Company was a holding com-

pany which owned controlling interests in the stocks of nine street-railroad and several electric lighting corporations.[1]

Prior to the enactment of the Public Service Commissions Law, such corporations as the Mohawk Valley Company could legally acquire and hold stock of railroad and lighting companies to an unlimited amount. Its operations had been conducted upon the assumption that this right involved the control and management of the companies in which it owned a majority of the stock, and financing had been carried on upon this basis. While it was still lawful for the Mohawk Valley Company to retain the ownership of the stocks which it then held, the provisions of the law would interfere seriously with the future financing and development of the properties.

The New York Central Railroad, the applicant corporation in this case, and also the owner of 60 per cent of the stock of the Mohawk Valley Company, submitted a plan of readjustment which involved a series of complicated changes in the holding of stocks and in the amount thereof of the various companies concerned in the transaction. The purpose was a change in the ownership of the stocks, to the end that the financial operations of the various companies might be placed in harmony with the existing law.

To this end it was proposed to do away with the existing holding company and unite all the street railway properties into one (street-railway) company by means of consolidation and merger where practicable and, where not, by stock ownership through transfer of stock; thus, a subsidiary of the Mohawk Company, an active company, and a street railroad company, was also to serve in the holding company capacity previously occupied by the Mohawk Company. This step, if approved, would place all these intercompany holdings in harmony with the law. The transfers involved in the plan were approved by the Commission as the best solution available.

Reasonableness of Price for Stocks Transferred

In a case of transfer of securities, especially where they are practically unlisted, and where the records of original investment are deficient or lacking, the question of the proper price to be paid is a difficult one unless recourse is had to a valuation of the physical property. In the discus-

[1] Matter of Applications of the New York Central and Hudson River Railroad Company for leave to acquire certain stocks and of the Rochester and Eastern Rapid Railway Company for authorization of the issue of capital stock, 1 P.S.C.R., 2nd Dist., N. Y., 294. Decided July 21, 1908.

sion in the Mohawk Valley case, the Commission speaks of "our inability to give a precise and definite answer upon a question upon which probably no two experts would exactly agree, to wit, the value of these stocks."

A similar case in the First District, the Matter of the Application of Coney Island and Gravesend Railway Company,[3] involved the purchase by one street railroad corporation from another of its entire outstanding capital stock at par. This brought up the question of the value of the stock. The majority opinion approving the transfer pointed out that the company had until very recently been earning 6 per cent dividends and would soon be doing so again, and that a large part of the road ran through a well developed section and the remainder through a rapidly developing section. The applicant company was itself a subsidiary of the Brooklyn Rapid Transit system and the proposed purchase of stock would bring it into operation as a part of the system. The majority of the Commission seemed to be convinced that a reduction of operating expenses could be brought about thereby and that the stock to be purchased could thus be made to earn more.

Several ways of fixing the value of the stock of a railroad corporation were pointed out by the Commission, as follows: Market value, earning power, and cost to reproduce the property; but it was agreed that there seemed to be no hard-and-fast rule. Market value, the Commission held, was always influenced by what was offered for the stock. In this case there was an outstanding offer for par, but it was felt that the very fact that another railroad company was in the market for the stock caused many holders to wait for a higher price. However, it was argued, to withhold consent to a purchase of stock of one railroad corporation by another, unless it was purchased at its actual market value, would likely stop all such contemplated purchases. Earning power was the element which, in the opinion of the Commission, is given most consideration by investors in railroad securities.

Cost to Reproduce as a Test of Value

In consideration of other data available as to the value of the stock in this case the ascertainment of the cost to reproduce new was felt to involve such an expensive and complicated investigation as to be hardly worth while, since it would be used merely as one of several tests. It

[3] Matter of Application of the Coney Island and Gravesend Railway Company for Authority to Acquire Capital Stock of the Coney Island and Brooklyn Railroad Company, 4 P.S.C.R., 1st Dist., N. Y., 490. Opinion adopted December 26, 1913

was held that if the Commission could arrive at the value of this stock from its market value and from its earning capacity, it should do so, and should resort to a re-valuation of the physical property only as a last resort, or if it had reason to doubt that the market value and the earnings shown were accurate.

In a dissenting opinion, Commissioner Maltbie contended that the claims of par value for the stock were not supported by any specific quotations for the stock, as far as such were available during the last few years. The Commissioner also claimed that a few years before the company had been barely saved from a receivership and reorganization proceedings, that it had for several years been paying dividends which had not been earned, and that the property had been allowed to run down.

There seemed to be a pronounced tendency in the majority opinion to use the anticipated advantages of the proposed merger as a basis for the transfer price of the stock. This would be, in effect, a capitalization of a contract for consolidation, which is expressly forbidden by law, whereas the minority opinion sought to arrive at the value of the stock as it was, independent of any proposed change in its control.

Propriety of Basing Permission to Transfer Stock Upon a Condition

Another point which involved a good deal of discussion in this case was the question as to whether approval of an application for a stock transfer could properly be based, in whole or in part, upon a condition. In this case the proposed condition was in the nature of a concession by the applicant's corporation in the service rendered to the public, a granting of additional transfer privileges in return for permission to consummate the proposed purchase of stock. One of the Commissioners, in supporting the majority opinion, stated that he voted aye

> upon the condition that an order be made requiring the companies of The Brooklyn Rapid Transit System (including The Coney Island and Brooklyn Railroad Company) to furnish transfers at every intersection of their surface railroad lines between the surface lines of these companies, so that a passenger may ride in the same general direction from a point of origin to a point of destination for a single fare of five cents.

As to the propriety of endeavoring to exact such a condition for the approval of the transfer of stock, the majority opinion took the following position:

> If this application to purchase stock is such as should be granted, an order to that effect should be entered. If the application is not such as should be granted, it cannot be made right by means of a bargain as to the giving of transfers.

Commissioner Maltbie in a dissenting opinion expressed himself as follows:

> The company has said that there will be economies in management and operation. The people are entitled to know whether all of these economies and advantages are to be kept by the companies, or whether the public is to reap some advantages from monopoly control. It is obvious that this question is a fundamental question in any application for the combination or consolidation of companies which have heretofore been competing companies.

The applicant corporation had contended, and the majority of the Commission seemed to take the same position, that the attaching of conditions to approval of an application for stock transfer would be an improper act upon the part of the Commission. In this connection the dissenting Commissioner argued as follows:

> I do not appreciate upon what grounds the impropriety would be based. It certainly cannot be upon the ground that the Commission has no power to attach any conditions to an approval, for that has been done in numerous cases, and I know of no instance where opposition to an Order has been based upon the theoretical ground that no conditions can be attached to an order of approval.

The Commission (First District) had in a previous case—the purchase of the stock of the Queens Gas Company and the Queens Gas and Electric Company by the Consolidated Gas Company of New York, attached to the order of approval a condition stipulating minimum prices for the purchase of stock from minority holders, and designed to protect them.[8]

A condition attached to approval of a transfer of stock, which pertains to the stock in question, may or may not differ from a condition relating for instance, to increased transfer privileges. It would seem that no logical objection could be raised to the attaching of a condition having to do with some phase of the stock transfer itself. The second kind of condition, involving concessions of one kind or another wrung from the applicant corporation, is open to some criticism, at least in theory. Such a basis of procedure has a 'trading-post' atmosphere about it. The attitude of the majority opinion, to the effect that if the application for transfer of stock was justified as such, it should be granted, and if it were not justified it could not be made right by means of a bargain, is sound in principle. Conditions relating to concessions suggest the methods prevalent some years ago in the granting of franchises by municipalities to public utility corporations. In such cases grants of fran-

[8] Matter of Application of the Consolidated Gas Company to Purchase the Stock of the New York and Queens Electric Light & Power Co., and the New York and Queens Gas Company, 4 P.S.C.R., 1st Dist., N. Y., 231. Opinion adopted May 20, 1913

chises to street railway companies were accompanied by conditions as to repair of streets, removal of snow, etc. In such bargaining there was no accurate ratio of value between the privileges given and the concessions obtained in return, and the way was opened to a system of trading in which the public often got little in exchange. Most serious of all, there was a tendency for 'log-rolling' to be accepted as the real basis to which the underlying principles were subordinated.

Of course, Commissioner Maltbie's idea was to give the matter of concessions a purely subordinate position. He simply maintained that if the companies involved would reap substantial financial advantage from the proposed transfer of stock, the public was entitled to some of this benefit, and, in defense of his attitude in this particular case, there might be noted, as mentioned above, the evident tendency of the majority of the Commission to justify the proposed price to be paid for the stock upon the financial benefits to be derived from the consolidation. The inherent objection to the introduction of the bargaining element, however, is the difficulty of keeping it in a properly subordinate position in the subsequent work of the Commission, and the tendency for it to become the practical, if not the officially recognized, basis in subsequent cases. On the other hand, any practice may, of course, be subject to abuse in the hands of lax or unscrupulous public officials.

The real crux in this case was that the Brooklyn Rapid Transit Company sought to gain all the advantages of unified operation without shouldering any of the disadvantages in the matter of concessions to the public. In a merger of street railway companies the new company must by law grant transfers over its entire system, but if one company merely consolidates with other companies it is not compelled so to do. By consolidating instead of merging, the Brooklyn Rapid Transit Company in this case sought to reap the benefits of control without being compelled by law to grant transfers. The same company has pursued this policy in numerous instances. Commissioner Maltbie was justified, therefore, in seeking, through administrative regulation, to secure to the public some of the financial benefit which would accrue to the company through unified control, and which the legal requirements governing mergers would have compelled it to grant. And since the Commission is the legislative agent of the public and has been entrusted with discretion to permit or withhold leave to consolidate, his position was sound.

Stock Transfer Based Upon the Writing Off of Intangible Values from the Capital Account

In contrast with the seemingly lax valuation of stock in the case just discussed, we might cite the action of the Second District Commission in connection with the application of the Buffalo General Electric Company to acquire the stock of the Cataract Power and Conduit Company.[4]

One ground of opposition was the fact that the Buffalo company proposed to issue its securities in payment for the stock of the Cataract Company. In the Cataract rate case it had been held by the Commission that none of this stock had been issued for cash or an equivalent in property.[5] The Cataract Company admitted this, but claimed that it had obtained very valuable intangible property in the shape of rights by the issuance of this stock.

The Commission decided that it could properly require the companies to write off a substantial portion of the intangible value represented by said stock as a condition of the approval of the stock transfer, and that this object could practically be attained by writing off the par value of the bonds of the Cataract Company, then outstanding to the amount of $1,384,000. This was, accordingly, made a condition of the merger. The result of such a course would be to enhance the value of the stock by that much, and the same result would have been accomplished as by letting the bonds stand and making a proportionate reduction in the price of the stock. We have here a good example of an attached condition pertaining to the stock transfer itself, as compared with a concession relating to service, as, e.g., increased transfer privileges.

Protection of Minority Stockholders

The protection of minority stockholders was emphasized by the First District Commission in an application of the Third Avenue Railway Company for permission to purchase a controlling interest in the stock of the New York City Interborough Company, of which it did not own a single share.[6] A controlling interest of 27,500 shares, out of a total of 50,000 shares had been secured. The petition stated that the company

[4] Matter of Application of Buffalo General Electric Company for authority to acquire the stock of the Cataract Power and Conduit Company, 4 P.S.C.R., 2nd Dist., N. Y., 528. Decided June 24, 1915.

[5] Matter of Application of L. P. Fuhrmann v. The Cataract Power and Conduit Company, 3P.S.C.R., 2nd Dist., N. Y. 656. Decided April 2, 1913.

[6] Matter of Application of the Third Avenue Railway Company to Acquire Certain Shares of the Capital Stock of Certain Street Railroad Corporations, 3 P.S.C. R., 1st Dist., N. Y., 327. Opinion adopted June 28, 1912.

could also acquire 1,150 shares at about $7.50 per share and 12,575 shares at an average of $18.10 per share, leaving a balance of 8,775 shares.

The question arose as to what justification there was for paying $18.10 per share for one block, and $7.50 per share for another, when the company would have a controlling interest without either. According to the testimony the higher price was to be a reward for the assistance the holders rendered "in conducting the negotiations and putting the thing through." Before the close of the hearings, however, the applicant withdrew this part of the petition.

The Commission wished to know whether the company would be willing to pay the holders of the remaining 8,775 shares of stock the average price paid for the last large block, $18.10 per share, and if not, what the company did propose for the protection of the minority interest. The company stated that it would not be willing to pay $18 per share for the minority holdings, and consequently, the Commission insisted that some provision should be made for the protection of the minority stockholders and that the company ought to state before the proceeding was closed what it was willing to do. The company finally stated that it would be willing to pay not to exceed $7 per share for all or any of the 21,530 shares outstanding, this being about the average price recently obtained for the shares in the open market.

This statement the Commission considered sufficient under the circumstances to remove any objection to the proposed purchase of stock upon this point.[7]

[7] For comparative purposes see Matter of Application of the New York Central and Hudson River Railroad Company and of the Lake Shore and Michigan Southern Railway Company for leave to purchase capital stock of the Lake Shore and Michigan Southern Railway Company, 4 P.S.C.R., 2nd Dist., N. Y., 258. Decided December 14, 1914. In this case reference is made to the provisions of the Ohio statute, under which non-assenting shareholders of a corporation proposing to consolidate with other corporations may demand purchase by the corporation of such non-assenting stock at a price to be determined in accordance with the provisions of the statute (General Code of Ohio, sections 9034, 9035 and 9036). The final test of price as fixed by this statute is the highest market value of such stock at any time within two years next preceding the making of the agreement for the proposed consolidation. The Taft Commission on Railroad Securities (1911) made a recommendation with regard to the protection of minority stockholders which the First District Commission endorsed and quoted in their opinion, and which is given herewith: "Any company or group of companies which has purchased a majority of the stock of any existing road may properly be required to buy the minority stock at the same price as that paid for the majority stock where the price has been uniform. If the price has not been uniform, the purchase should be either at the average price paid for such holdings or at a price to be fixed by appraisal, at the option of the minority stockholders."

The duty of protecting the minority stockholders was again dwelt upon in a dissenting opinion by Commissioner Maltbie in a First District case involving the purchase of a controlling interest in the Queens Electric Company by the Consolidated Gas Company of New York City.[8] The Consolidated Company had not been able to secure options upon all of the common and preferred stock of the electric company and yet objected to a condition in an order of approval which would require it to purchase all or none of the capital stock. As long as there was a minority interest which the Consolidated Company did not control, it was contended that that minority interest might be affected adversely by the majority. The Order approving the purchase of stock which was subsequently issued contained a hard and fast condition for the protection of these minority stockholders. This provided that within a year from the date of the Order minority-owned stock, preferred and common, should be purchased by the company when offered at the prices stipulated in the Order for each kind of stock.

Denial of Consent to Stock Transfer Based Upon Inadequate Protection to Minority Holders

In an important Second District case involving the purchase of railroad stock, the necessity for protecting minority stockholders was indirectly responsible for the denial of the application. The New York Ontario & Western Railroad Company was a railroad corporation of the State of New York, whose capital stock, issued and outstanding, consisted of 581,139 shares of common and 40 shares of preferred stock, each of the par value of $100. The par value of the common stock was $58,113,900 and of the preferred stock $4,000. The New York New Haven and Hartford Railroad Company owned 291,600 shares of the common stock of the par value of $29,160,000, and 22 shares of the preferred stock of the par value of $2,200. The New York Central and Hudson River Railroad Company made application[9] for authorization to purchase all of the above-mentioned capital stock owned by the New York New Haven and Hartford Railroad Company.

[8] Matter of Application of the Consolidated Gas Company of New York for Authority to Purchase the Stock of the New York and Queens Electric Light and Power Company and the New York and Queens Gas Company, 4 P.S.C.R., 1st Dist., N. Y., 231. Opinion adopted May 20, 1913.

[9] Matter of Application of the New York Central and Hudson River Railroad Company for authorization to purchase from the New York, New Haven and Hartford Railroad Company stock of the New York Ontario and Western Railroad Company, 3 P.S.C.R., 2nd Dist., N. Y., 261. Decided April 2, 1912.

The Commission held that the motive was obviously to gain control, that such control could then be exercised either for the benefit of the Ontario and Western, or for the benefit of the Central, and that the relations of the two roads would be such that the majority control could easily dictate courses which would as a whole be advantageous to it, although not profitable to the Ontario and Western. Such a possibility, it was contended, would make easy an oppression of the minority stockholders which it would be hard for the courts to prevent.

In denying the application the Commission expressed itself as follows:

> No transfer of a bare majority interest from the New Haven to the Central should be permitted without reasonably guarding the minority from possible oppressicn by the majority interest. No means are apparent by which this can be done in this case except by imposing as a condition of the authorization that the Central shall take over such of the minority stock as may be offered it upon the same terms per share as it pays the New Haven.

If the minority stockholders saw fit to avail themselves of this privilege, the Commission pointed out, the Central would be compelled to assume a purchase price of substantially $26,000,000, and an annual fixed charge for interest of substantially $1,150,000. The Commission expressed itself as unwilling to impose such a burden upon the Central and as unable to perceive any advantages which in its judgment would compensate for the disadvantages involved in such an investment.

Permission to Consolidate Based upon Advantage to Minority Stockholders

In direct contrast with this case was the application of the New York New Haven & Hartford to purchase from the New York Central a controlling interest in the stock of the Rutland Railroad Company.[10] On December 27, 1911, the New Haven Company filed a petition asking leave to purchase from the New York Central the 47,041 shares of the preferred stock of the Rutland Company, which the latter owned. The petition was duly granted.

Among its reasons for the authorization the Commission held that:

> The New York Central, which at present controls the Rutland, is to a material extent a competitor with the Rutland; while on the other hand the Rutland is, by its

[10] Matter Application of T. C. Delavan for an order to declare null and void the purchase by the New York, New Haven and Hartford Railroad Company from the New York Central and Hudson River Railroad Company of stock of the Rutland Railroad Company, 3 P.S.C.R., 2nd Dist., N. Y., 492. Decided December 18, 1912.

connection with the Boston and Maine a natural extension of the New Haven system as at present operated, and that the natural effect of the control of the Rutland by the New Haven will be to increase competition and induce a very considerable increase of business over the Rutland from and to New England points.

The Commission emphasized the fact that it still adhered to the principle laid down by it in the Ontario and Western case, namely, that in transfers of control of a subsidiary railroad proper protection should be afforded to the rights of minority stockholders. It held, however, that it did not necessarily follow that in every case the purchasing road should offer to the minority stockholders the same price for their stock which it was willing to pay for control. While such a condition might well be imposed in a case where the transfer would create a control which did not theretofore exist, in the present case the control was already in the hands of the Central, and the relief sought was merely the transfer of that control to the New Haven. If the result of the transfer to the New Haven would be to increase the business of the Rutland and thereby increase its revenues, it would be to the advantage of the minority stockholders.

The Absorption of Competing Companies

One of the most fundamental questions involved in many stock transfers is the consideration of the effect upon the general public, the consumer, of the acquisition of control of one company by another. It may be for the worse, or, contrary to general opinion, it may be for the better.

Into this category we would put those cases in which the transfer causes an actual change in existing conditions, from an operating as well as from a financial point of view, and not such cases as, for instance, the purchase by a leesee road of the stock of a subsidiary road already under lease for 99 years, for the purpose of facilitating the issue of needed securities. In the latter case the change is not in actual operating relations, but in financial relations, and such a change tends to make possible improvements in the already existing conditions of operation, and is, therefore, beneficial to the travelling public.

Elimination of Competition not a Valid Reason for Consolidation

In connection with the application[11] of the Third Avenue Railway Company to purchase a controlling interest in the stock of the New York City Interborough Railway Company, the president of the applicant

[11] Matter of Application of the Third Avenue Railway Company to acquire Capital Stock of Certain Street Railroad Corporations and to Issue Bonds, 3 P.S.R.C., 1st Dist., N. Y., 327. Opinion adopted June 28, 1912.

company testified that the chief reason why his company desired such control was to prevent the New York City Interborough Company from dividing the earnings of the Third Avenue in the Bronx. The Commission held that such a reason—the elimination of competition—was invalid from the public standpoint; that competition in itself was desirable and beneficial and that it was only when the attendant evils were so objectionable that they outweighed the benefits of competition that competition should be restricted; and that if the only result of the acquisition of the stock of the New York City Interborough Company by the Third Avenue Company were the elimination of competition between the former company and the Union Company,[12] such acquisition should not be approved. However, it was felt by the Commission that there were other considerations.

An examination of a map showing the lines and franchises of the various companies in the Borough of The Bronx indicated that the New York City Interborough Company tapped only in part the same areas supplied by other companies, and that the unification of the two systems would in those areas eliminate competition of a general character only. The Commission was convinced that a unified system could be operated with greater harmony and that schedules could be arranged to provide better connections at non-rush hours; that paralleling of lines could be avoided, and that there were possibilities of economies in management and operation. For these reasons permission to consolidate was granted.

Effect upon Public Interests of Consolidation of Gas and Electric Utilities

In 1912 the Consoliated Gas Company of New York City applied[13] for permission to purchase controlling interests in the stock of the New York and Queens Gas Company, and in that of the Queens Electric Light and Power Company. The most important point involved was the extension of the monopoly of the Consolidated Gas Company into new territory, both as to gas and electricity. The latter company owned all the capital stock of the New York Edison Company, which supplied most of the current in Manhattan. On the other hand most of the directors

[12] The Interborough Company had been organized in 1902, for the purpose, it was said, of competing with the Union Company. The entire stock of the Union Company was owned at this time by the Third Avenue Company.

[13] Matter of Application of the Consolidated Gas Company for authority to Purchase the Stock oι the New York and Queens Electric Light and Power Company and the New York and Queens Gas Company, 4 P.S.C.R., 1st Dist., N. Y., 231. Opinion adopted May 20, 1913.

of the Queens County Gas Company were also directors of the Queens Electric Light and Power Company, so that while there were two separate organizations, they represented the same interests. Thus, the majority of the Commission felt that the granting of the applications would make little difference in the existing condition as far as the control of gas and electricity by the same interests was concerned.

Commissioner Maltbie filed a dissenting opinion, in which he approved the application in regard to the Queens Gas stock, but vigorously opposed the acquisition by the Consolidated of the Queens Electric stock, contending that even if the applicant were to present a plan which removed the minor objections, there would remain a far more important objection inherent to the matter of control. For if the application were granted, the Consolidated Gas Company would control, through the ownership of the majority of stock in the Queens Electric Company, practically the whole supply of electricity in the Borough of Queens and also control the gas supply in Wards No. 1 and No. 3, and franchises for the supply of gas in other districts. "Through its control of these subsidiary companies," Commissioner Maltbie claimed, "it would be able to determine the policy of each, the extent to which new processes, inventions and methods should be introduced, the vigor with which each service should be pushed as against the other, and the degree to which electricity would be allowed to compete with gas or vice versa."

Regulated monopoly as illustrated by Commission control, it was contended, was not intended to do away with fair competition as an economic factor in the control of public utilities, but was to be used only in those cases where competition had failed to protect the public interest. The gas and electric industries were regarded as belonging to the class where experience had shown regulated monopoly to be the best means of protection to the consuming public, but the question which in this case appealed to Commissioner Maltbie as of fundamental importance was "not whether gas companies supplying the same area should be allowed to consolidate, but whether companies supplying competing services, namely, gas and electricity, should be permitted to come under a single control." In answer the Commissioner stated:

It should first be pointed out that the arguments which are made in favor of monopoly in each of these industries do not apply to monopolistic control of both industries. The plant and facilities of a gas company are entirely different from those of an electric-supply company. Each must have its separate generating plant, its distribution system, its organization, its staff of engineers, experts and employees, etc. The plant and facilities used by the gas company could not be used by an electric company even if both were under the same control, and the elimination of inconvenience to the

public caused by the duplication of property in the streets, interruptions of traffic and injury to paving could not be urged as a reason for unity of control, because the distributing system of the gas company is entirely separate and distinct from that of the electric company, and consolidation would not lessen street work.[14]

In this case, the two companies involved, the New York Edison Company and the Queens Electric Company, both had business of such magnitude as to need no assistance from the other and there seemed little possibility of a saving in "overhead expense" as each company could fully employ a large staff of men.

A further objection was expressed by the Commissioner as follows:

. . . control of gas and electricity by a single company, or of separate companies supplying these services through a holding company, may retard the natural development of each, prevent the rapid introduction of new processes, inventions and methods and repress the keen rivalry which competition between the two services would naturally produce. . . .

. . . The tendency of monopoly is towards apathy, delay in adopting inventions which will improve service, but not increase income, indifference to the needs and demands of consumers, and lack of responsiveness to changing conditions which alert management should constantly show. When competitive services are brought under single control, monopoly is at its worst, for it has eliminated, not only competition between those supplying the same service, but competition between those supplying competitive services.

Permission to the transfer of stock was granted, the majority of the Commission holding that the service would be improved and the efficiency of operation increased; that the proposed action should be approved in order that the plants and facilities of the Queens companies could be made adequate to the needs of the rapidly growing population in the area of supply. Much weight was given to the plea advanced by the Consolidated Company that without the assistance of the Consolidated Gas Company the other companies whose stock it wished to purchase would find it difficult, and perhaps impossible, to finance the cost of improvements and extensions.

An interesting sequel came two years later in the application[15] of

[14] For similar discussions see Matter of Application of the Watertown Light and Power Company and the Watertown Gas Light Company for approval of a consolidation, 1 P.S.C.R., 2nd Dist. N. Y., 496. Decided March 9, 1909, also Matter of Application of Palmyra Gas and Electric Company, etc. etc., for Approval of Consolidation into Wayne County Gas and Electric Company, 2 P.S.C.R., 2nd Dist., N. Y., 500 Decided June 22, 1910.

[15] Matter of Extension of Gas Mains of the New York and Queens Gas Company to Serve Residents of Douglaston, etc., 6 P.S.C.R., 1st Dist., N. Y., 35. Opinion adopted February 11, 1915.

See same case 6 P.S.C.R, 1st Dist., N. Y., 187. Order entered March 19, 1915

residents of a section of the Borough of Queens, known as Douglaston, for the extension of gas mains by the New York and Queens Gas Company. This section was already being furnished with electricity, but not with gas. The company (now owned by the Consolidated Gas Company) refused to lay a main because it claimed that the proposed extension would not pay interest charges for some time, and it took the position that it ought to be assured that it would earn at least 6 per cent on the entire cost of the extension before it was required to construct such an extension. The Commission promptly decided to compel the company to lay the main, as required to furnish the applicants with gas. Commissioner Maltbie, in writing the majority opinion upon the case, observed that

> it is surprising that so soon after the decision permitting the Consolidated Company to acquire control of the New York & Queens Gas Company, that company should refuse to make extensions to Douglaston unless it is assisted financially by the consumers themselves.[18]

[18] The comment of Commissioner Williams, who had supported the approval of stock transfer when it was up for consideration, is interesting, and is quoted herewith: "Record me in the affirmative for the reason that, when the stock of the company was acquired by the Consolidated Gas Company of New York, one of the arguments used on behalf of the applicant was that just such extensions as this could be made if the company were controlled by the larger company, on account of the larger company being better able to finance, and that it was also stated in that hearing that many mains would have to be built which would not pay a return for some time. This, I believe, is one of them."

As an instance of the extent to which legal procedure may be availed of by a corporation for purposes of delay the subsequent history of the Commission's Order in this case is of interest. The Company appealed from the Order of the Commission to the Appellate Division of the Supreme Court, which handed down an Order annulling the determination of the Commission upon March 3, 1916. (171 App. Div. 580.) The Commission appealed to the Court of Appeals, which reversed the Order of the Appellate Division, October 3, 1916. (219 N. Y. 84.) A motion by the Company to the Court of Appeals for reargument was denied December 28, 1916. (219 N. Y. 681.) The Company then appealed, (under the Fourteenth Amendment) to the United States Supreme Court, which sustained the judgment of the Court of Appeals, December 10, 1917. (245 U. S. 345.) The company applied to the Commission for rehearing and same was denied February 1, 1918. (9 P.S.C.R., 1st Dist., N. Y., 259.) The Company then sued out a writ of *certiorari* before the Appellate Division of the Supreme Court (N. Y.) to review the Commission's Order denying the application for a rehearing. This writ was quashed April 5, 1918.

As a result the Company is now obliged to carry out the original Order of the Commission at a time when prices and wages are enormously increased over the scale obtaining when the Order was originally issued.

Stock Transfers Based Upon General Advantage to the Public

Most transportation systems, whether railroad or street railroad, are, to a greater or less extent, a patchwork of originally independent units, built up through purchase of stock control, or long-term leases. A purchase of the remaining stock, or, in the case of a leased property, of all the stock, in no way alters the actual *status quo*. In these cases the relations have been fixed for so long a time that the subsidiary corporations are integral parts of the system from an operating point of view, and it is desirable for many reasons that they should also become so from a financial viewpoint. In thus broadening and stabilizing the credit of a system and so facilitating the financing of improvements and extensions, stock transfers are of indirect public benefit.

Such an instance occured in connection with the application[17] by the New York Central for permission to purchase the entire capital stock of the Spuyten Duyvil and Port Morris Railroad. This company owned a line of railroad between Spuyten Duyvil, a point upon the east bank of the Hudson River just north of the most northern point of the Island of Manhattan, and Mott Haven Junction on the East River, a distance of 5.31 miles. The capital stock of the railroad was $989,000, par value, and its line was used as a part of the main track of the New York Central and Hudson River Railroad, all through trains for the north and west running over its tracks, as well as all local passenger trains of the Hudson River division. It was thus a most vital part of the great New York Central system, the key of its entrance into the city of New York.

In 1871 a lease had been made to the New York Central for 99 years at a rental of 8 per cent on the outstanding capital stock. In view of the amount of money which the New York Central had hitherto invested upon this leased line and was investing in its passenger terminals in New York City the Commission approved the application.

The same general situation was involved in the matter of the application[18] of the New York Central for authorization to buy all or any part of the capital stock of the New York and Harlem Railroad Company at a price not exceeding $175 per share. The New York and Harlem Rail-

[17] Matter of Application of the New York Central and Hudson River Railroad Company for leave to purchase the stock of the Spuyten Duyvil and Port Morris Railroad Company, 1 P.S.C.R., 2nd Dist., N. Y. 466. Decided January 22, 1909.

[18] Matter of Application of the New York Central & Hudson River Railroad Company for authorization to buy the stock of the New York & Harlem Railroad Company, 3 P.S.C.R., 2nd Dist., N. Y. 183. Decided December 28, 1911.

road Company owned a greater part of the Grand Central Terminal in the city of New York, and a line of railroad from that city to Chatham with a small branch extending to Port Morris. These properties had been leased to the applicant on the 1st day of April, 1873, for a term of 401 years.

It appeared that the Central, if it purchased the entire stock of the Harlem upon the terms mentioned, would increase its fixed charges to the amount of $153,000. The Commission was convinced that the advantages to be obtained were sufficient to over-balance this increased charge, and authorization to purchase the stock was granted.[19]

Acquisition of a Minority of Stock by a Corporation Already in Control

In September, 1912, application was made[20] for the authorization of the purchase by the Third Avenue Railway Company of 13,560 shares of the capital stock of the New York City Interborough Railway Company in addition to 28,650 shares theretofore acquired and owned by the Third Avenue Railway Company. This would give the applicant company 42,210 shares out of a total of 50,000.

The Commission took the position that the general question as to whether the Third Avenue Company should be permitted to acquire any stock of the New York City Interborough Company had been considered and disposed of in the preceding case,[21] and that the only questions here involved were those in connection with an increase of holdings in view of the fact that the Third Avenue Company already owned and controlled a majority of the stock of the New York City Interborough Company. Authority to acquire and hold the said 13,560 shares was granted.[22]

[19] See also Matter of the Application of the South Brooklyn Railway Company to purchase stock in the Prospect Park and South Brooklyn Railroad Company, and in the New York and Coney Island Railroad Company, 3 P.S.C.R., 1st Dist., N. Y. 464. Opionion adopted July 2, 1912.

[20] Matter of Application of the Third Avenue Railway Company to Purchase, Acquire, Take and Hold Certain Shares of the Capital Stock of the New York City Interborough Railway Company, 3 P.S.C.R., 1st Dist., N. Y. 447. Opinion adopted November 8, 1912.

[21] 3 P.S.C.R., 1st Dist., N. Y. 327. This case was discussed above under the heading "Elimination of Competition not a Valid Reason for Consolidation."

[22] The purchasing corporation proposed to finance the purchase by the issue of promissory notes payable not more than one year from date, for which the authority of the Commission was not necessary, and in this connection the opinion emphasized

Along the same line were two applications, one in 1909,[23] and the other in 1911,[24] respectively, concerning purchases by the Baltimore & Ohio Railroad of relatively small amounts of Staten Island Railway stock of which it already owned an overwhelming majority. Since this was the case, the applications were granted, practically without comment, although the Commission stated that if the Baltimore & Ohio had not already had a controlling interest there should have been a thorough investigation as to all the facts and the probable effect of the passing of control of this local corporation into the possession of a foreign corporation.[25]

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the fact that any action taken upon the pending application for purchase in no way committed the Commission to an approval of an issue of securities in case the company at some future time should desire to pay off the short term notes by the issuance of bonds or stock.

[23] Matter of Application of the Staten Island Railway Company for Approval of Transfer to the Baltimore & Ohio Railroad Company of Capital Stock of the former, 1 P.S.C.R., 1st Dist., N. Y. 788. Opinion adopted August 27, 1909.

[24] Matter of Petition of the Baltimore & Ohio Railroad Company for Leave to Acquire Certain Shares of the Capital Stock of the Staten Island Railway Company, 2 P.S.C.R., 1st Dist., N. Y. 782. Opinion adopted December 30, 1911.

[25] In this connection see Matter of Application of the New York Central and the Lake Shore and Michigan Southern Railroad for permission for the former to purchase capital stock of the latter, 4 P.S.C.R., 2nd Dist., N. Y. 258. About 95 per cent of the outstanding stock of the Lake Shore was already owned by the Central. Permission granted. Decided December 14, 1914.

As an example of the acquisition by a street railroad corporation of an additional issue of stock of a subsidiary street railroad corporation of which it already owned all the existing bonds and stocks, we might cite the application of the Belt Line Railway Company to issue $269,000 of capital stock to defray the cost of acquiring 79 storage-battery cars for operation upon its lines, 4 P.S.C.R., 1st Dist., N. Y. 411. The Third Avenue Company, which owned all of the bonds and capital stock of the Belt Line Corporation, asked for authority to acquire, take and hold all of the new capital stock. Permission granted. Opinion adopted November 7, 1913.

In the case of subsidiary corporations organized for feeder purposes, or where small and struggling corporations have been bought up and heavily financed by the controlling corporation, the Commissions have made little objection to the acquisition of further issues of the subsidiaries by the larger corporations. The preceding case is a typical instance. We might cite also the application, 6 P.S.C.R. (1st Dist., N. Y.) 189, of the Third Avenue Railway Company to purchase the entire capital stock of the Third Avenue Bridge Company. Opinion filed March 23, 1915.

See also, the Matter of the Application of the Pelham Park and City Island Railway Company, Inc., for permission to issue capital stock, together with a request for permission to transfer to the Interborough Rapid Transit Company, which already owned all the outstanding stock of the applicant corporation. Permission granted. See 4 P.S.C.R., 1st Dist., N. Y. 314. Opinion adopted May 27, 1913.

[5] See, in addition, Matter of the Application of the Third Avenue Railway Company for Consent to Purchase Capital Stock and Bonds to be Issued by the Mid-Crosstown Railway Company, Inc., 5 P.S.C.R., 1st Dist., N. Y. 22. Opinion adopted January 23, 1914.

Matter of Application of the Astoria Light, Heat & Power Company, for Authorisation of the Issuance of Bonds and Stock, 5 P.S.C.R., 1st Dist., N. Y. 225. Decision rendered May 4, 1914.

Matter of Application of the New York Edison Company for an Order Authorizing the Issuance of $15,800,000 Additional Capital Stock, 5 P.S.C.R., 1st Dist., N. Y 230. Decision rendered May 4, 1914.

Two other cases involve the transfer and re-transfer of stock to facilitate reorganization proceedings. They are, first, the Matter of the Application of the Receivers of the Metropolitan Street Railway Company (1909) to Purchase from the Receiver of the New York City Railway Company the Stock of the Bridge Operating Company owned by the latter, 1 P.S.C.R., 1st Dist., N Y. 741. Opinion adopted August 20, 1909; secondly, the Matter of the Application of the New York City Railway Company, in 1914, to re-purchase the same from the Metropolitan Company, 5 P.S.C.R, 1st Dist., N. Y., 251. Opinion adopted June 2, 1914.

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For references to laws, court decisions and opinions of the Commissions see front of book.